TESTIMONY OF E.F. HEIZER, JR.
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
NOVEMBER 8, 1979

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting Heizer Corporation to testify again before your Subcommittee relative to H.R. 3991, the Small Business Investment Incentive Act of 1979.

I am appearing before the Subcommittee as Chairman of Heizer Corporation along with our special legal counsel, Ray Garrett.

Although I have been an active participant in the venture capital industry for many years and am currently on the Board of Directors of both the National Venture Capital Association and the National Association of Small Business Investment Companies and am currently Chairman of the Task Force on Capital Formation for the White House Conference on Small Business, I will restrict my testimony this morning to the perspective of Heizer Corporation on exemption from the Investment Company Act of 1940.

If the Subcommittee so desires and time permits, I will of course be pleased to answer any questions you may have or to appear again and expand my testimony relative to the other aspects of H.R. 3991.

The message I hope to leave with you this morning is that the venture capital industry needs legislative relief from the Investment Company Act of 1940, that administrative relief is too uncertain and costly in both time and money, and that the public can be adequately protected without the 1940 Act applying to venture capital firms.

As explained in my testimony before the SEC in its regional meeting in Chicago on May 9, 1978 and before this Subcommittee in its hearings on September 27, 1978 (copies of the previous testimonies are attached), the 1940 Act has served and will continue to serve a useful public purpose relative to conventional investment companies, whether closed-end or mutual funds. However, when the 1940 Act is applied to the venture capital industry, it becomes at best unwieldy and in practice debilitating.

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 latest victim, Continental Capital, will testify at these hearings. Today, only a handful of public companies operating under the 1940 Act, such as Narragansett which will also testify at these hearings, try in any significant way to provide equity capital to small business and they only

do so after extraordinary effort, needless delays, and unnecessary expense. I emphasize equity capital since it is much more feasible to supply debt capital operating under the 1940 Act than it is equity capital. Supplying equity capital is the principal function of the venture capital industry.

Even more damaging to the country than the demise of those firms which tried to work under the Act and gave up in utter frustration is the very much longer list of firms that have gone out of business rather than try to operate as registered investment companies because they believed they could not function effectively under the 1940 Act. Today, the typical venture capital firm is structured to self-liquidate within ten years or less largely because of the 1940 Act. As a result, the country is not building the permanent infrastructure it needs to build our economy. In fact, the situation is so bad that the SEC often says there is no one hurt by the 1940 Act or, in the alternative, there is no one who needs relief from the 1940 Act. The net effect has been to seriously impair the flow of equity capital to new businesses and to deny the public the right to invest in professionally managed venture capital firms. Heizer

55-753 O - 80 - 17

Corporation, which is the country's largest independent venture capital firm is currently exempt from the 1940 Act since it has less than 100 shareholders, but will join the list of victims unless effective relief is obtained from the SEC or Congress.

In September 1979, Heizer Corporation celebrated its tenth anniversary, but was unable to tell its shareholders whether or not it could continue as a company. After ten years, our investors deserve, and many must have, liquidity for all or part of their investment. We must plan to liquidate Heizer Corporation or obtain exemption from the 1940 Act so we can go public as a continuing firm while our investors are free to sell all or part of their investment. We feel that Heizer Corporation's common stock could be a good long-term investment for the public shareholders and that Heizer Corporation would continue to make an important contribution to our economy. More important, we feel that many other venture capital firms would be able to revise their plans and become continuing businesses.

You have probably heard that Heizer Corporation has been working with the SEC for exemptive relief and that the SEC, by an order applicable only to Heizer Corporation, may give exemptive relief that will enable Heizer Corporation at

least to survive as a registered investment company with public ownership of its stock. Why, then, does Heizer Corporation or the venture capital industry need legislative relief?

Although it is true that

- Heizer Corporation has been working closely with the SEC;
- The SEC staff has been fully cooperative;
- The SEC staff wants to help Heizer Corporation;
- The SEC staff wants to help the venture capital industry;
- The SEC staff is considering exemptive relief for Heizer Corporation, consistent with that special brand of protection of the public shareholders imposed by the 1940 Act;

it is also true that

- Heizer Corporation has been plagued by the uncertainties of the 1940 Act for ten years, even though it has not registered under the 1940 Act;
- Heizer Corporation has had a concerted life-or-death effort going with the SEC for over a year to obtain meaningful exemptions;

- Heizer Corporation has had the assistance of very able and experienced legal counsel;
- Heizer Corporation has incurred over $300,000 of direct out-of-pocket expenses on its outside legal counsel for this effort;
- Heizer Corporation's total cost on the 1940 Act already is at least $500,000;
- Heizer Corporation has not been able to do new deals for five years largely due to the uncertainties caused by the 1940 Act;
- Heizer Corporation has not been able to build the type of continuing management team it would like to build because of uncertainties of the 1940 Act;
- Heizer Corporation's efforts to help its present investees have been seriously hampered due to the 1940 Act;
- Heizer Corporation has not yet obtained exemptive relief from the SEC;
- Heizer corporation may never obtain exemptive relief from the SEC;
- Even if Heizer Corporation does obtain adequate exemptive relief, Heizer Corporation and the SEC will be faced with costly and unproductive red tape and filings that really do little to protect the public. At the same time, Heizer Corporation's ability to take advantage of new investment

opportunities and to meet the needs of its investee companies, under conditions as they may be in the future, will be sharply circumscribed.

None of this is really the fault of the SEC or its staff. The fault lies with the 1940 Act itself and must be remedied by Congress. From a legislative standpoint, Congress should ask itself some very basic questions:

- 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 publicly-traded venture capital firms? We say emphatically NO. The 1940 Act is not needed to protect the public. With a 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 emphatically NO. The 39-year record speaks for itself.
- Is the 1940 Act typical of the kind of legislation that our Constitution envisioned?
  - The 1933 and 1934 Acts assume you are innocent until proven guilty and then you are entitled to a trial to determine if you did anything wrong and, if so, was anyone damaged and, if so, what were the damages.

- The 1940 Act assumes you are guilty until proven innocent and the penalty is complete rescission of your transactions without proof of harm to anyone, with no statute of limitations, with no trial.

. Should other venture capital firms be asked to go through what Heizer Corporation has been going through even if you assume that Heizer Corporation eventually obtains meaningful exemptive relief from the SEC?
  - Heizer Corporation says emphatically NO.
  - Very few venture capital firms can afford the cost of hiring competent counsel for this purpose.
  - The fear, uncertainties and cost would continue to discourage venture capital firms from planning to be continuing companies.
  - Public investors would continue to be denied access to professional management.
  - The flow of equity funds to new businesses would continue to be severely restricted.
  - The future of America's new and innovative companies would continue to reside in the hands of relatively few firms representing only the big institutions and a few extremely wealthy families.

We compliment the Subcommittee on Consumer Protection and Finance for addressing this key and long overdue issue. We urge Congress to proceed quickly, before any more damage is done to our economy, to pass H.R. 3991 or an appropriate compromise with the companion bills in the Senate.

ATTACHMENT I

STATEMENT OF E. F. HEIZER, JR.

BEFORE THE SECURITIES EXCHANGE COMMISSION

May 9, 1978

I am E. F. Heizer, Jr., founder and President of Heizer Corporation in Chicago, Illinois.

Heizer Corporation is the largest independent venture capital firm in the United States. We are in the business of providing equity capital to start-up and early stage growth businesses. Our objective is to build highly successful, independent public companies. We help to produce new products and services for better living through financing; more jobs, lower prices, less inflation, more exports, more federal and local taxes. The Government and the economy has everything to gain and nothing to lose by supporting the venture capital community.

I am not here today to address myself to the fine tuning of

Rule 144
Rule 146
Extension of Reg. A Exemption
Use of S18 vs. S1
Cost of SEC Compliance

These are the domains of the lawyers and accountants. The SEC is well aware of the issues in these areas. Many well qualified people have testified as to the improvements that should be made. The SEC is to be commended for its long-term continuing efforts to balance the protection of the public with the need to provide an effective flow of capital. These hearings are an important new effort by the SEC to hear what the business community feels can be done to increase the flow of capital to new businesses.

I am here to address a very basic and little understood restriction on the flow of capital, namely, the unfortunate application of the Investment Company Act of 1940 to the venture capital community. The 1940 Act is a law that is so debilitating to venture capital firms that no venture capital firm can prosper and survive under it. Therefore, there are very few people to explain how they were in effect put out of business by the SEC. The few healthy venture capital firms which exist today are free from the 1940 Act, having been financed by wealthy families or large institutions.

It is absolutely unbelievable to me that the SEC is in effect saying that public investors cannot invest in professionally managed venture capital firms which invest in the future of America while at the same time the SEC allows the public to gamble in the non-productive options market with little professional management or safeguards.

<u>Why is the 1940 Act so debilitating to venture capital firms?</u>

1. Because management is prohibited from having an equity position under the 1940 Act.

2. Because the 1940 Act prohibits control of investees directly or indirectly through affiliates.

3. Because follow-on investments must be approved by the SEC through time-consuming and expensive Section 17 filings.

- As to 1 above, venture capital investing is hard night-and-day work akin to being a doctor in private practice--as contrasted to a mutual fund manager investing in public securities where the investee lives on no matter what the mutual fund manager does or does not do. Competent venture capitalists deserve and should have an equity participation to compensate them for the many years of hard work necessary to be successful and to create a continuity of interest between the venture capitalist and the investors.

- As to 2 above, venture capital firms should assume control alone or through affiliates. To invest significant funds and not take control over the typical entrepreneur would be imprudent and counter-productive. The typical entrepreneur needs the help of the venture capitalist. The SEC should not deny this help.

- As to 3 above, all important ventures require a series of follow-on investments. These must often be made with little time to debate the issues. The Section 17 filings

are totally nonresponsive to the realities of the venture capital business. A dying company in need of money to meet is payroll cannot wait 3 to 9 months for the SEC to approve its survival.

Is the 1940 Act needed to protect the public investor?

No, it is not needed.

There is nothing a venture capitalist can do which is improper which is not covered by other state and federal laws and regulations.

Did Congress mean to cover venture capital firms under the 1940 Act?

No, the failure to exempt venture capital firms from the 1940 Act was an oversight. The 1940 Act was aimed at preventing mutual funds from self-dealing in "publicly" traded securities.

The restrictions of the 1940 Act have little or no application to the venture capital industry.

The venture capital industry invests "privately" in investee companies. It finances payroll, R&D, new plants and new equipment until a company is self-supporting. It cannot sell its securities for many years -- at least 5 years and more often 10 to 15 years after it makes its investment. When a venture capital firm does sell it must do so through SEC registration or Rule 144. It does not trade in public securities like a mutual fund; therefore, the public does not need the protection of the 1940 Act in the case of a venture capital firm.

Congress exempted from the 1940 Act all financial businesses which invest "directly" in other companies, including "small loan, industrial banking and similar businesses." In 1940 there were no SBIC's nor was there a venture capital industry as such to exempt or they would

have been exempted by Congress. Today there are approximately 100 privately financed venture capital firms represented by The National Venture Capital Association (NVCA), and approximately 300 government financed Small Business Investment Companies represented by the National Association of Small Business Investment Companies (NASBIC) and regulated by the Small Business Administration (SBA).

Would exemption of venture capital firms from the 1940 Act help the economy?

Yes, it would.

Venture capital is the adrenaline of the free enterprise system. It is absolutely essential to new business formation and to a growing and healthy economy.

Unfortunately the sources of venture capital have been steadily drying up in the United States for many years as our money has become more and more institutionalized.

Wealthy individuals, insurance companies, banks and investment bankers all used to be the key sources of venture capital. Through our tax laws and other various well intentioned government legislation, these sources of venture capital have been all but eliminated.

Now ERISA has virtually cut off all pension fund money from the venture capital industry.

As a result, the venture capital industry is a fraction of the size it should be for the United States to continue to have a healthy and growing economy.

Freeing up the venture capital industry from the 1940 Act would be an important and positive step towards filling a growing national need. Unfortunately, this step alone will not suddenly create a surge of new venture capital firms but in time would lead to a much larger, more stable, and better managed venture capital industry.

Heizer Corporation is the largest independent venture capital firm in the United States.

- Since 1969 Heizer Corporation has financed 32 companies.
  - 18 are already successful growing companies
  - 4 more are expected to be successful
  - 10 have been failures
- Through these companies,
  - Over 36,000 jobs have been created (Heizer Corporation's share is over 6,000 jobs)
  - Over $2 billion in sales have been generated (Heizer Corporation's share is over $370 million).
- Equally impressive figures are available from the American Electronics Association, Massachusetts Institute of Technology NVCA, NASBIC, SBA and others.
- In effect, the U.S. Government owns approximately 50% of every company Heizer Corporation finances with no investment.
- Heizer Corporation investees are now producing over $280 mill. of taxable income each year.
- The cost per "permanent" job created has been a "one-time" cost of about $13,000 vs. the "annual" cost of $20,000 per job created by the U.S. Government.
- Heizer Corporation's assets have grown through internal development from $81 million in 1969 to over $200 million in 1978.
- Heizer Corporation has been successful despite the worst stock market and bond market conditions since the 1930's.
- The Country needs more venture capital firms since there is little competition in the venture capital industry and the bright young man or woman finds it increasingly difficult to realize the "American Dream."

Unfortunately, Heizer Corporation could not be formed today.

Heizer Corporation was formed in 1969 under an unusually favorable set of conditions, which may never occur again.

- E. F. Heizer, Jr. had unusual top management support from and as a result, an excellent record in building Allstate's venture capital program in the 1960's.
- Interest rates were low.
- Stock prices were high.
- Many institutions wanted to do what Allstate had done.
- E. F. Heizer, Jr. was in the right place at the right time and in 1969 was able to raise $81 million privately from 35 institutions free from the 1940 Act.

What is equally disturbing to the fact that Heizer Corporation could not be formed today, is that now Heizer Corporation will probably have to be liquidated due to the 1940 Act.

- Heizer Corporation's investors understandably want liquidity after ten years.
- Heizer Corporation cannot go public to give them liquidity without falling under the 1940 Act.
- Heizer Corporation cannot operate under the 1940 Act.
- Therefore, Heizer Corporation must be liquidated.

We submit that this is not in the best interest of Heizer Corporation's investors or investees, the public or the U.S. Government.

We have had the best legal counsel available on this subject, namely, Ray Garrett, former SEC Chairman. He is sympathetic to our cause but discouraging in terms of the SEC history with the 1940 Act.

Like Humpty Dumpty
Heizer Corporation Built A Success
Now It Faces Liquidation Stress.
Once It Has Liquidated,
All The Government Agencies And All Heizer Corporation's Men
Cannot Put It Together Again.

The SEC should not only ask what it can do to protect the public from the excesses of the free enterprise system, but also ask what can the SEC do to help the free enterprise system help the economy and thus the public.

The one thing the SEC should not do is to continue to impede the progress of the venture capital industry under threat of the 1940 Act simply because somehow, someday, some venture capital firm might do something wrong. The SEC should prosecute any venture capital firm that does something wrong under other laws and regulations.

We urge the SEC through its own rule-making ability or through supporting legislation to exempt all venture capital firms -- private and SBIC which invest "directly" in the securities of investees-- from the 1940 Act and the Investment Advisory Act.

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TESTIMONY OF E. F. HEIZER, JR. ATTACHMENT II
BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
September 27, 1978

Mr. Chairman and Members of the Committee:

It is a great honor and privilege to appear before you this morning.

My name is Ned Heizer. I am Chairman and founder of Heizer Corporation, which is the largest Business Development firm in the United States. Heizer Corporation specializes in providing equity capital to start-up and early stage growth companies.

I have been an active member of the venture capital community, having served as President and Chairman of the National Venture Capital Association and I am currently serving on the boards of both the National Venture Capital Association (NVCA) and the National Association of Small Business Investment Companies (NASBIC). NVCA represents the privately financed venture capital firms and NASBIC represents the SBA financed venture capital firms. I am formally here this morning as a representative of NVCA but I believe that my remarks will be supported by both NVCA and NASBIC.

We would like to thank this Committee and the Securities and Exchange Commission for the work you have done to improve the security laws and regulations. Our industry is pleased with the progress that has been made regarding:

- Regulation A
- Rule 144
- Rule 146

therefore I will not comment on these provisions this morning.

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

are only a few 1940 Act venture capital firms to talk to you about their problems.

Many members of the venture capital industry are equally concerned about the Investment Advisory Act. For purposes of clarity, I will address my remarks to the 1940 Act, but please remember that many of the same points I will make also apply to the Investment Advisory Act.

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

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

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

But tax incentives alone will not solve our basic problem of grossly inadequate new capital formation -- except perhaps for our larger more successful companies.

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

On the other hand, individuals are not a reliable source of risk capital. The security laws of the Federal Government and the states have understandably been steadily developed to protect the public from taking risks. Even if we had no security laws it would be very difficult to assemble the public funds in a meaningful way to develop new and growing companies.

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

What the country needs is more professionally managed venture capital firms. Today the venture capital industry -- SBIC's and privately financed firms -- are basically noncompetitive. For instance, in its nine-year history, Heizer Corporation has only been able to finance 33 companies out of over 6,000 which have requested help and has experienced no competition in the process. All the members of NVCA and NASBIC put together -- which constitute the bulk of all business development capital in the United States -- have invested less money per day over the last twenty years than Amtrak currently loses per day. Although saving the passenger rail service may be a fully justified

government activity, we submit it is imperative for the Government to encourage a greatly expanded flow of capital to new and growing businesses.

Your committee can make a great contribution by working with the Securities and Exchange Commission to formulate new legislation which will exempt all firms which invest long-term capital directly and privately from the provisions of the 1940 Act.

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

The protective provisions of the 1940 Act are not needed in the case of venture capital firms which invest directly and privately. Anyone who purchases directly and privately is subject to the 1933 and 1934 Acts as well as to a wide range of other federal and state laws and regulations.

The Securities and Exchange Commission has traditionally said that there is no reason that a well managed venture capital firm cannot operate under the 1940 Act and therefore, no change in the law is required. The testimony of all those who tried and failed to operate successfully under the 1940 Act should be ample proof that exemption is necessary in the national interest but even better proof is that after 38 years no successful venture capital firm is operating under the 1940 Act and NVCA and NASBIC agree that exemption is absolutely critical to the future growth of the venture capital industry.

Without going into the details of the 1940 Act, it calls for a series of reports to and prior approvals by the Securities and Exchange Commission intended to protect the independence in terms of ownership and control and transactions between the 1940 Act companies and their investees which may be fitting and

55-753 O - 80 - 18

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

The practical effect of the 1940 Act is twofold:

- First, to avoid the crippling effects of the 1940 Act, venture capital firms must have less than 100 security holders and must typically plan to liquidate within a seven-to-ten year period. Thus, even the best firms rise and fall within a relatively short period of time.

- The public is denied the opportunity to invest in the future of America through diversified and professionally-managed venture capital firms. Only wealthy families and a few venturesome institutions can participate in financing the future of America.

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

So that there will be no misunderstanding as to my own motivation, I would like to end with the following statement:

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

- Heizer Corporation has been successful in that the companies Heizer Corporation has financed which would not exist without Heizer Corporation now have over $1 billion in sales, $150 million in

taxable income and have created over 20,000 permanent jobs.

- Adding to this list those companies financed by Heizer Corporation to which Heizer Corporation was a very important but not vital source of risk capital, the combined sales would exceed $2 billion, taxable income would exceed $286 million and new jobs created would be 36,500.

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

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

- Unfortunately, the 1940 Act says Heizer Corporation must be liquidated. The reasons are as follows:
    - Heizer Corporation investors understandably want liquidity on all or part of their investment after ten years of locked in investment.
    - Heizer Corporation cannot provide its investors with meaningful liquidity without having more than 100 shareholders.
    - Having more than 100 shareholders would put Heizer Corporation under the 1940 Act.

- Heizer Corporation cannot continue to operate successfully under the 1940 Act.
- Heizer Corporation is very skeptical about obtaining a meaningful exemption from the Securities and Exchange Commission although Heizer Corporation and the Securities and Exchange Commission are trying to work out a meaningful solution.
- The only practical answer appears to be liquidation. This is especially so when you consider the difficulty Heizer Corporation is having in obtaining relief despite its size, record and able representation by Ray Garrett, former Chairman of the Securities and Exchange Commission. The 1940 Act is an impossible barrier for the smaller venture capital firms.

This, as far as Heizer Corporation is concerned, is a life-or-death matter. Speaking for the venture capital industry after 20 years of experience, this is a matter of vital concern. Speaking as a citizen, this is a matter of great national importance.

Like Humpty Dumpty
Heizer Corporation Built A Success
Now It Faces Liquidation Stress
All The Government Agencies And
All Heizer Corporation's Men
Cannot Put It Together Again.

The NVCA and NASBIC stand ready to work with your Committee, your counterpart committee in the Senate, and with the Securities and Exchange Commission to develop a constructive legislative solution to the serious problems created by the 1940 Act and the Investment Advisory Act.

Thank you for your attention.

Mr. BROYHILL. We are delighted to have you back before the committee and of course I recall our work together when you were Chairman of the SEC, when we were working on the revisions of the act back in the mid-1970's.

Mr. GARRETT. I remember that very well, Mr. Broyhill.

Mr. BROYHILL. If you would like to summarize your statement, Mr. Garrett.

STATEMENT OF RAY GARRETT, JR.

Mr. GARRETT. I would be glad to. I assume my prepared statement will be in the record.

Mr. BROYHILL. We will put it in the record [see p. 279].

Mr. GARRETT. In my prepared statement, I request that there also be placed in the record a memorandum, dated May 18, 1979 that was prepared for and submitted to Chairman Williams of the SEC. This is it.

Mr. BROYHILL. We will place the memorandum in the record following your prepared statement [see p. 291].

Mr. GARRETT. We provided copies to Ms. Marion Reid of the subcommittee's staff this morning.

Mr. BROYHILL. All right.

Mr. GARRETT. Thank you. This memorandum was prepared as a result of a meeting Mr. Heizer and I had with Chairman Williams of the SEC after this subcommittee's hearings in September 1978. At that meeting, we agreed with Chairman Williams that we would explore with the staff of the Division of Investment Management the possibility of exemptive rulemaking before the next round of legislative consideration came to pass, and that we would advise him of the results.

We began these discussions in January of 1979 and the May 18 memorandum is a report of our ultimate frustration. The final impasse was the staff's refusal and inability under the law as they conceived it, to consider any kind of rule that would exempt venture capital companies from 1940 act registration altogether, if venture capital company shares would be available to ordinary investors—something that we thought was essential to achieve the necessary liquidity. The memorandum recites the several varieties of definitions and conditions and standards that we proposed, but ultimately we were told that this basic objection could not be overcome by our ingenuity.

We have accepted, however, the staff's willingness to discuss an order granting particular exemptions to Heizer Corp. on the assumption that Heizer would register as a closed-end investment company under the act.

Mr. Heizer made some reference to these discussions. If it comes to pass and it looks as though we can get an order that would enable Heizer Corp. to stay in existence as a publicly held company, at least on a tentative exploratory basis to see whether they can make it, the management of Heizer Corp. may decide to do so. Our discussions with the staff are continuing, and there has been good progress in some areas. But we are still not sure that we will reach a satisfactory solution.

I think the emphasis, however, from your point of view, should be on the fact that at best such an order would not be a substitute

for legislation of the kind here being considered, either for Heizer Corp. or, more importantly, for other persons in the business. In this regard, I think counting the existing firms that might be able to take advantage of any proposed legislation is not going to give the full picture, because we are concerned with unborn children. We are concerned with venture capital firms that don't exist because they cannot see their way either to begin, or ultimately to become publicly held, without registration under the 1940 act.

I assume the proposition that venture capital companies cannot and will not try to operate as registered 1940 act companies without very extensive exemptions does not need to be further demonstrated at this time to this subcommittee. As an exhibit to the May 18 memorandum we prepared for the SEC, however, there is a copy of our December 1978 memorandum on this subject, which we prepared at your request, Mr. Broyhill, as well as the request made by Mr. Eckhardt during the subcommittee's September 1978 hearings. This is as complete a job as we could put together exploring the types of difficulties that the management of a venture capital company encounters in trying to deal with the 1940 act. You also have heard some other vivid testimony on the subject during the present hearings and I understand you will hear some more from Mr. Chambers.

The necessary exemptions to avoid these problems are such that, in our judgment, it makes more sense to grant a properly circumscribed exemption from registration than to insist upon registration and then proceed to carve up the act, so to speak, by granting particular exemptions. It also, in our judgment, is a better policy approach, especially for the SEC. Rather than try to decide which small businesses should be helped at the expense of which investor protections, we think it better and wiser to define an exempt category of venture capital companies which do not require the smothering embrace of the 1940 act investor protections. This is the fundamental approach that the SEC staff has rejected, explaining they think this is beyond their reasonable interpretation of the act's purpose, and I think beyond their own beliefs as to what ought to be done. But we do urge the Congress to accept this approach.

The SEC is inclined to talk in this area as though the 1940 act is the only act available to save small investors from abuses at the hands of management. I think this is not a well-founded or realistic view of the legal and practical situation. There are about 10,000 U.S. companies with enough public ownership to be registered under the Exchange Act. There are only a few hundred closed-end investment companies registered under the 1940 act. There are a lot more mutual funds, but they are in a category by themselves.

The small investors in these 9,500-plus companies that are not under the 1940 act are not without legal protection against abusive management. They are not thrown to the wolves by our law or our legal system. They have working for them the disclosures required by the Exchange Act, and, on appropriate occasions, those required by the Securities Act. They have the legal remedies provided by those acts, what the common law provides, they have State law on fiduciary duties enforceable by derivative and class actions, and

they have the SEC's enforcement efforts and, on occasion, also those of the Department of Justice.

All of these companies are potentially subject to abuse from self-dealing by insiders. They are potentially subject to unwise capital structures. They are potentially subject to almost everything else that the 1940 act talks about. But even the more aggressive, more ardent reformers today, who would tighten up the fiduciary duties of corporate management and make more legal remedies available, do not propose the 1940 act-type of protection.

Consider, for example, self-dealing by insiders. For ordinary companies this is handled by disclosure, plus threat of litigation in which the insider must prove fairness. The 1940 act, however, approaches this problem by making any such transaction illegal unless the SEC, by an administrative proceeding and order, declares it to be fair. And then the 1940 act extends the definition of what I am loosely calling an insider transaction to a bewildering extent by its definition of affiliates and affiliates of affiliates.

As to capital structure, this is a complex subject for any business enterprise on which views frequently differ, but this is one on which the 1940 act and it alone—except for the 1935 act relating to public utility holding companies—is exceedingly doctrinaire, and even quaintly puritan, with respect to the amount of asset coverage required for senior securities, debt and preferred, and, of more significance to most people, its total prohibition against what the industry calls equity kickers, conversion features, warrants, options, and things of that sort.

But for all of our other 9,500 companies that are not blessed with this kind of investor protection, what is relied upon is disclosure, market forces, the good judgment of management, the good judgment of investment bankers and brokers that either deal in securities, underwrite them, or recommend their purchase or sale, and sometimes shareholder approval. And nobody has suggested that we should undertake an across-the-board prohibition against American industry issuing convertible securities. Nobody is that smart as to know when they are good or bad.

The 1940 act presumes that investment company shareholders will be a docile group of wholly unsophisticated persons who cannot handle information from disclosure and that they must therefore be protected by the Federal Government from, for example, investing in a company with convertible securities outstanding. With respect to the typical purchaser of a mutual fund—peddled at farmhouse doors and in little towns to people who are looking for a savings device—it may not be a bad assumption. Although I don't speak in any official sense for mutual funds, they have been able to live without much difficulty under this prohibition, so if closed-end investment companies that are conventional investment companies are buying or selling securities, query whether they need to borrow at all, on even a short-term basis and query even more whether they have any business even thinking about a convertible debenture offer, for example.

But investors in venture capital companies are not going to be people at farmhouse doors. They are going to be people that have money that they want to risk. They are going to know through 1933 act and 1934 act disclosures—at least they will have the

information available to them—what they are investing in. In addition, under suitability and other rules governing our broker-dealer community today, venture capital company securities are not going to be pressed upon the people that can't handle any kind of risk, or, if they are, there are plenty of remedies available.

You wonder why this heavy paternalism for investment company shareholders. There has been some argument in the record as to what Congress had in mind in 1940; whether it knew that venture capital companies existed or might exist.

I agree with the Commission staff's memo. Congress knew that venture capital firms might exist. But it is also true that there weren't any of any substance around, nor was anybody speaking for them when the act was being drafted, the act being dominated by the SEC staff and by committees representing mutual funds and closed-end companies. Closed-end companies, incidentally, were the big villains of the stock market crash. Mutual funds were little things in those days and hadn't yet gotten themselves in much trouble. But nobody was there talking about venture capital companies.

The act came about because Congress, in adopting the 1935 act, the Public Utility Holding Company Act, directed the SEC to make a study of the functions and activities of investment trusts and investment companies and the influence exerted by interests affiliated with the management of such companies upon their investment policies and to report the results of its study and its recommendations to Congress.

It has been very popular in the last few weeks to revisit the Black Tuesday, and Black Wednesday, and Black Thursday in the crash of October 1929. I don't agree with Professor Galbraith on a lot of things, but he has written one of the most interesting and lively books on the subject, "The Great Crash of 1929," and there you will find, constantly repeated, that the earliest companies to fall flat on their faces were some of the investment companies that had been created, mostly by bankers and investment bankers in New York, as repositories for dogs that they were trying to underwrite that nobody would buy, and a variety of other things of that kind. There were plenty of reasons for Congress to want the SEC to study this area, none of them having anything to do with venture capital companies.

The Senate Committee on Banking and Currency, in adopting the act, stated that:

> Basically the problems flow from the very nature of the assets of the investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile, and readily negotiable. * * * These assets can and have been easily misappropriated and diverted by such types of managements and have been employed to foster their personal interests rather than the interests of the public security holders.

That is as good and authoritive a statement as we can find as to what conceptually distinguishes the entities that were intended to be subject to this peculiar paternalistic form of investor protection from all the rest of the corporate world.

It also suggests, however, that the better approach to excluding venture capital companies from this extraordinary form of regulation is to define them so that their assets are not predominantly

cash and securities which are completely liquid and readily negotiable and so that they do not primarily have assets that can easily be misappropriated and diverted by such types of managements and employed to foster their personal interests, and to provide some protection against what the Senate committee called such types of managements, meaning in those days managements entirely dominated by insiders who were making money off the investment funds on the side. Funds in those days were all managed by somebody that had something else going for him rather than the welfare of the investors and shares or participations in the fund itself, a fundamental problem that the 1940 act deals with very effectively.

This approach is far more promising than trying to govern what types of investments made by venture capital companies are good and which are bad.

On the other side, if we really think that the dangers are present that Congress found in conventional investment companies in 1940, then we ought not to expose small investors to those dangers just for the sake of helping small business.

As a semifinal point, I think it is also interesting to note, and it may be pertinent thinking in this area, that the SEC is taking a curiously unbalanced view of shareholders protection in its small business program.

After all, the Securities Act of 1933 is devoted to shareholder protection through disclosure and improvement in shareholders legal remedies. The SEC has been aggressive and imaginative in adopting rules and is considering even more rules which make it easier legally for small businesses to sell shares directly to small investors, but the price of this is at least a marginal lessening of the Securities Act type of investor protection.

But there are many risks in direct investment by small investors in the shares of new and unseasoned companies. And if a new and unseasoned company, taking advantage of the expanded 1933 act exemptions, provides only limited information to investors, particularly if it is in a technology field, small investors may not even understand what the issuer is doing or proposes to do, much less be in a position to make any reasoned judgment as to its success in trying to do it.

The risks in small business investments also include, in addition to what could be regarded as basic risks of the sucess or failure of the business, the ineptness of management in critical areas. A common and crucial problem with many small businesses is that they are good at their main thing, whatever their main thing is, but weak in finance, marketing, accounting controls, and things of that sort. And there is nothing to protect an investor in the small business from unethical behavior by management. Being small does not necessarily make you more moral, more ethical. It may even make you more greedy when you look at the way in which some investors have been treated by small or medium-sized businesses, and it may be more likely to involve persons with no professional experience in the management of publicly owned companies, or persons who lack any proper concern for the interests of investors altogether.

The small investor, in making these investments, is not even assured that the board of the small business company will have independent directors to oversee the conduct of management. If it is desirable to increase the exposure of small investors to these risks, and I am quite prepared to agree that it is, why is the SEC suddenly addressing measures to prevent small investors from buying shares of venture capital companies? Even under the most gloomy view of the probable behavior of the management of a venture capital company, the risks to small investors are significantly less, or should be in the ordinary case, than they will be from direct investments in small businesses.

The risks in venture capital investments can be further reduced, if the subcommittee wishes, by some changes in the exemptive provision, and here there are two existing patterns which Mr. Heizer has alluded to in his closing remarks.

I think the simplest, readiest place to turn are two bills pending in the Senate, the first in time being S. 1533, which was submitted by Senator Tower. In addition to the substantive requirements in section 6 of H.R. 3991, plus an exclusion for the purchase of short-term paper to preclude any danger that someone might try to run a money market fund under this exemption—probably a nonexistent danger anyway, considering the tax laws—S. 1533 would provide that, to be exempt from the 1940 act, the venture capital company must meet additional conditions. These requirements are, to summarize what takes a lot of words in the bill, that—

The venture capital company must have a majority of independent outside directors;

All securities held by the venture capital company, exclusive of Governments, commercial paper and the like, must be treated as restricted as to resale regardless of how they were acquired, to discourage any free trading or running a market operation on the side; and

No director, officer, employee, or controlling person of the venture capital company may own securities of an investee company, and no affiliate of any of the foregoing may do so without the approval of a majority of the outside independent directors otherwise uninvolved in the transaction; and—the venture capital company must have been in the venture capital business for at least 5 years.

The other pending bill in the Senate, submitted much more recently by Senator Nelson, is styled, appropriately enough, S. 1940. It is, in the above-mentioned respects, similar to S. 1533, the Tower bill, but without the 5-year provision.

Both of these strike us as a reasonable way to add additional protections to the basic exemption for venture capital companies, to the extent it is regarded as necessary to protect against misconduct on the part of the management of the venture capital company. These requirements would, I might say, afford more protection in this direction than would be applicable to the 9,500 industrial companies that are also under the Exchange Act.

Thank you very much, Mr. Broyhill.

[Testimony resumes on p. 471.]

[Mr. Garrett's prepared statement and the December memorandum referred to follow:]

STATEMENT OF RAY GARRETT, JR.
BEFORE THE SUBCOMMITTEE ON
CONSUMER PROTECTION AND FINANCE
OF THE HOUSE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE

November 8, 1979

Mr. Chairman and members of the Subcommittee, my name is Ray Garrett, Jr. I am an attorney with the law firm of Gardner, Carton and Douglas, and my firm is Special Counsel to Heizer Corporation. I am pleased to have the opportunity to be here today with Ned Heizer to testify in support of legislation to remove the obstacles to venture capital companies that are posed by the Investment Company Act of 1940.

As this Subcommittee is aware, and as other witnesses at these hearings have emphasized, it has become increasingly difficult, and often impossible, for small but promising new or emerging businesses, particularly those in high-risk or high-technology fields, to obtain long-term equity capital through our public securities markets or from the large institutional investors which today predominate in those markets. The economic and social consequences of this lack of available financing, in terms of new job opportunities that could be provided, but are not; creative new ideas for services, technological innovations, and scientific breakthroughs which might be successfully developed, but are not; and increased tax revenues which could be generated, but are not -- just to name a few examples -- are obvious. And they affect all of us.

I do not mean to suggest, of course, that the Investment Company Act of 1940 is the sole or even a principal cause of the current shortage of capital for small businesses. The causes are many and are extremely complex. But the 1940 Act is a very real and a very serious legal impediment to at least one key source of capital for new and emerging enterprises -- that provided by professionally managed venture capital firms. It is an impediment that, in my judgment, serves no useful public purpose, in terms of investor protection or otherwise. If anything, it is simply an historical accident, reflecting a failure by the Congress, the SEC and others concerned with the legislation that became the Investment Company Act

-- to recognize in 1940 that the broad definition of the term "investment company" would extend the coverage of that Act to entities which bear scant resemblance to traditional types of investment companies, such as mutual funds, at which the Act was primarily aimed;

-- to appreciate that the intricate regulatory and proscriptive provisions of the Act that can be beneficial to mutual fund or closed-end investment company shareholders without crippling the operations of those entities could have so devastating an impact on venture capital companies; and

-- to foresee the dramatic changes that have occurred

in our capital markets since 1940 which have sharply increased the need for publicly-held venture capital companies.

In 1940, most venture capital was provided by wealthy individuals or families. This is no longer true today. In 1940, there were few venture capital companies that raised capital from either private or public investors. Today, there are a few more venture capital companies, but, with the exception of a handful of SBIC's, none are publicly-held; most are precluded from looking to the public markets either for capital to fund their business development activities or as a means to provide their existing investors with liquidity and an opportunity to realize upon gains they may have earned. Many venture capital enterprises are organized in limited partnership form, with a view from the outset of their operations to liquidation after a fixed period of years. Others are organized as corporations, but if they prove to be successful and profitable, they find themselves faced with the unhappy choice of liquidating, like the limited partnerships, or merging into entities engaged in other businesses. Continued long-term operation in the venture capital field simply is not feasible for most such entities.

The reason lies in the Investment Company Act of 1940. To state the problem simplistically, when a venture capital

company seeks to make a public offering of its securities, or its securities become beneficially owned by more than 100 shareholders, it becomes an "investment company" as defined in the 1940 Act. It then must register as such with the SEC, and thereafter comply with the full panoply of regulatory strictures imposed by that Act and the SEC's rules.

The Act's intricate regulatory scheme, which was designed to protect shareholders in mutual funds and conventional closed-end investment companies, is simply unworkable for venture capital companies. Many of the key elements of venture capital financing, such as taking substantial, and often controlling, positions in investee companies, supplying investees with prompt infusions of additional capital when needed and awarding the incentive compensation essential to attract and retain talented and highly motivated venture capital company personnel, involve transactions that are prohibited by the 1940 Act, unless the SEC can be persuaded to grant relief by order -- a procedure which is time-consuming and expensive, even when successful. Moreover, the process of identifying each "affiliated person" and each "affiliated person of an affiliated person" before entering into an otherwise normal business transaction and then, if necessary, obtaining specific approval of the transaction by SEC order is simply inconsistent with the practical exigencies of

developing new business enterprises. In fact, these requirements are so burdensome and impractical that today no true venture capital company operates under the 1940 Act; the few that have tried have given up.

As a result, the venture capital that is available today to finance small or emerging enterprises is in short supply -- far less than our economy could use or should have. I do not believe that this shortage can be attributed solely or even primarily to a lack of interest or other incentives to investment in this important sector of our economy. Rather, I believe that many potential investors in small businesses today, whether they be large institutions or individuals, shy away from such investments because they do not have the time or the experience needed to select promising investment opportunities in small or emerging businesses, particularly those involved in complex scientific or technological fields, or to provide such enterprises with the active management assistance so necessary to the successful development and marketing of new ideas and products. Professionally managed and staffed venture capital companies could help to fill this gap, by providing a mechanism through which more capital could be channeled into the small, innovative businesses which are so essential to our continued economic growth and prosperity.

But this will never happen if venture capital companies themselves continue to be denied the broader-based funding that could be supplied by public investors, and remain precluded from providing liquidty to their initial investors through the development of public markets for their own equity securities, because of the 1940 Act.

The problem would be different and more difficult if venture capital companies presented in full measure the opportunities for the abuse of shareholders by insiders and affiliates that led Congress to enact the special regulatory protections of the 1940 Act for traditional investment companies. In fact, although venture capital companies hold securities issued by other companies, this is their only real similarity to conventional investment companies. Because they do not control large pools of liquid assets and have a low rate of portfolio turnover, venture capital firms present little, if any, of the same potential for abuse, and their shareholders do not need the unique regulatory protections of the Investment Company Act. Indeed, as the sponsors of H.R. 3991 and similar bills that have been introduced in the Senate correctly recognize, the full measure of investor protections afforded by the Securities Act of 1933 and the Securities Exchange Act of 1934 -- the full and fair disclosure, continuous reporting and proxy requirements, the proscriptions against insider trading,

the antifraud prohibitions and the civil liability provisions --and by the requirements of state law concerning the fiduciary obligations of corporate management, would apply to any venture capital company which seeks to raise capital from the public, or is publicly-held, on the same terms as any other company. In my judgment, these protections are enough; the public interest and the interests of investor protection do not require more.

The question has been put, why should venture capital companies be given special treatment? Stated more sharply, are we saying that the protection of small investors should be sacrificed for the benefit of small, new businesses? The phrasing of the question about special treatment reflects a narrow view of American corporations and the law applicable to them. Of the approximately 10,000 publicly-held companies registered under the Securities Exchange Act, only a few hundred are also subject to the 1940 Act, and almost all of them are readily identifiable - mutual funds, conventional closed-end investment companies, and a handful of SBIC's. Investors in all of these other 9,000-plus companies get along without the peculiar kind of additional protection imposed by the 1940 Act. And even the most ardent corporate reformers are not proposing the broadening of 1940 Act-style protection. It is the companies caught in the net of the 1940 Act that get the special treatment. The others get

the ordinary treatment. We are urging that venture capital companies, properly defined, get the ordinary treatment. And we urge that this be done not by deciding that small businessmen are more worthy than small investors but by defining exempt venture capital companies so as to avoid the peculiar opportunities for abuse that gave rise to the 1940 Act.

In addressing this subject, the SEC is inclined to talk as though the 1940 Act is the only thing that would keep the investors in venture capital companies from being thrown to the wolves. This is, of course, quite unrealistic. There are opportunities for the managements and affiliates of all companies to abuse their investors in the ways of such concern to the 1940 Act. The remedy for all of corporate America except registered investment companies is disclosure plus state law, enforced mainly through derivative and class actions. This is what we want for venture capital companies.

As Special Counsel to Heizer Corporation, I have worked closely for the past fourteen months with Ned Heizer and others from his firm, and with the SEC staff, in an effort to find an administrative solution to the problems posed by the 1940 Act for venture capital companies. Our initial goal was to persuade the SEC to adopt rules of general applicability that would exempt venture capital companies

from the entire 1940 Act, or at least those provisions of the Act which are unworkable when applied to such companies. In April of this year, however, the SEC staff advised us that they could not support any rule that might permit venture capital companies to make public offerings of their securities to ordinary investors while exempt from the 1940 Act, thus quashing our hopes for a rulemaking solution to the liquidity needs of Heizer or any other venture capital company that plans to be a continuing entity. The staff also indicated to us, as did the Commission in its August 1979 comments on H.R. 3991, that they intended to try to develop a rule proposal that would make it easier for venture capital companies to obtain initial financing from substantial and sophisticated investors, by excluding such investors from the computation made to determine if a venture capital company has not more than 100 beneficial owners of its shares and can qualify for an exemption under Section 3(c)(1) of the Act. We have not yet seen a draft of such a rule. But if, as the Commission suggested in its August 1979 comments on this bill, such a rule incorporates the definition of "business development company" contained in recently-proposed Investment Advisers Act Rule 205-3, it will not provide relief to a large segment of the venture capital industry. And even if such a rule would make it easier to start a venture capital company, it would do nothing to provide for future liquidity.

When it became apparent, after many months of discussions with the SEC staff, that we could not expect a rule to help solve the venture capital industry's liquidity problems, we began to explore the possibility of obtaining a limited exemption from the 1940 Act, by Commission order, for Heizer Corporation alone. Although good faith efforts have been made on both sides, and we are most appreciative of the substantial time and effort that has been devoted to our problems by the SEC staff, to date we have been unable to reach a mutually-satisfactory accommodation with the staff on several key issues that must be resolved if Heizer is to be able to function as a venture capital company registered under the 1940 Act. We have not yet given up; we intend to continue to try and hope that the SEC staff will bear with us. But the outcome remains uncertain at best, and even if Heizer Corporation is successful in obtaining a limited order of exemption from the SEC after a year or more of sustained effort and substantial legal expenses, little will have been achieved for the economy beyond permitting Heizer to stay in business. If the only hope for ultimate liquidity while continuing to function as a venture capital company is to recapitulate Heizer's experience, the 1940 Act will remain a formidable obstacle to the growth of venture capital financing in the dimensions that our economy requires.

With the Subcommittee's permission, I would like at this time to submit for inclusion in the record of these hearings a memorandum, dated May 18, 1979, which contains a detailed description through that date of our discussions with the SEC staff concerning relief from the 1940 Act for Heizer Corporation and other venture capital companies. Exhibit I to that memorandum is the submission we prepared for this Subcommittee last December describing the legal and practical problems presented for venture capital companies by the 1940 Act, and I believe it will help those members of the Subcommittee who have not previously seen it to understand the nature and extent of these problems.

At this point, I think it is clear, as perhaps it should have been from the beginning, that a realistic and workable long-term solution to the problems caused by the 1940 Act for the venture capital industry as a whole can only come through the enactment of legislation. There seems to be little chance that the Commission will find the adoption of a rule, granting relief that is broad enough to meet the industry's needs, consistent with its responsibilities under the Act in its present form. I can understand why the Commission may feel bound to strictly enforce the application of the Act to all who fall within its broad definition of investment company. But the Congress is subject to no such constraints and quite properly can and

should re-examine the Act. If that re-examination shows, as I am confident it will, that there is no public purpose to be served by continuing to subject venture capital companies to all of the peculiar restrictions of the Act, then Congress should promptly amend the Act to remove these unnecessary burdens from those companies that, like Heizer, have simply been caught on the wrong side of the line in the Act's effort to separate investment companies from all other companies but that present few, if any, of the opportunities for abuse beyond those present in any ordinary corporation.

Although I have limited my prepared remarks to the 1940 Act problems addressed by H.R. 3991, I will be pleased to respond to any questions the Subcommittee may have concerning other aspects of the bill, as well as the provisions relating to the 1940 Act.

M E M O R A N D U M

SUBJECT: Summary of Discussions with the Division of Investment Management Concerning Relief for Heizer Corporation and Other Business Development Companies from the Investment Company Act of 1940

FROM: Gardner, Carton & Douglas

DATE: May 18, 1979

Beginning in the fall of 1978, Heizer Corporation, with the support of the National Venture Capital Association and the National Association of Small Business Investment Companies, has led a concerted effort to obtain relief from the Investment Company Act of 1940 for business development companies* in general and itself in particular. Through its outside general counsel, McDermott, Will & Emery (Mr. John H. McDermott), and its special counsel, Gardner, Carton & Douglas (Messrs. Ray Garrett, Jr., Paul H. Dykstra and David F. Heroy and Mrs. Kathryn B. McGrath), Heizer has submitted a series of informal written proposals for relief to the Division of Investment Management of the Securities and Exchange Commission and has participated in three meetings in

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* In most of the discourse on this subject, the customary term for the investing entity has been "venture capital company." However, because many entities describing themselves as "venture capital companies" appear not to be in fact engaged in the socially desirable activity of furnishing capital directly to new or developing businesses or participating in any significant way in their development, the term used by Heizer Corporation--"business development company"--was adopted in Mr. Garrett's letter of April 13, 1979, to describe entities that are so engaged. We shall use the term "business development company" in that sense in the remainder of this memorandum, even though the term "venture capital company" may have been used in earlier submissions.

Washington and numerous telephone discussions with members of the Division. Those in the Division who have been principally involved in these discussions are Messrs. Sydney H. Mendelsohn, Director of the Division; Martin E. Lybecker, Associate Director; Sidney L. Cimmet, Chief Counsel; and Lawrence R. Bardfeld, Staff Attorney.

This memorandum will describe the main aspects of those discussions and will chronicle the evolution of Heizer's requests for relief.

SUMMARY

It is imperative that Heizer Corporation obtain liquidity for its initial investors in the reasonably near future or it will be compelled to terminate its operations as the nation's largest independent business development company. Investor liquidity, however, demands registration as an investment company, and the Investment Company Act of 1940 (the "1940 Act") as currently administered by the Commission is incompatible with the successful operation of a business development company. Heizer can continue only if it obtains meaningful and swift relief from the 1940 Act.

The SEC staff has cooperated with Heizer's counsel in considering the problems posed for business development companies by the 1940 Act. One could not have asked for more attention or a fairer hearing. Regrettably, however, virtually no progress has been made in solving these problems as far as Heizer is concerned.

The staff have persisted in the position that they will not agree to an exemption from registration under the 1940 Act for an established business development company like Heizer if

its shares can be traded in small pieces and are thus available to ordinary investors. This position has been maintained regardless of the efforts by Heizer's counsel to suggest increasingly stringent protective provisions by way of conditions to the exemption. Yet it remains the strongly held view of Heizer and its counsel that only total exemption on reasonable terms will attract that degree of capital and entrepreneurial effort necessary to make a significant contribution to this aspect of our economy.

With respect to Heizer Corporation alone, the staff has advised that no significant relief will be accorded by Commission rule-making; if any relief is to be granted, it will be only after formal administrative hearings with a full record of the proceedings. This process, the staff has estimated, could take eighteen months or more. Thus Heizer has, in effect, been sent back to where it was two years ago, with an invitation to explore the possibility of obtaining limited exemptions for itself alone, based upon its registration as an investment company and only after protracted hearings with an uncertain outcome.

To be sure, the staff's support for a rule exempting from the 1940 Act business development companies whose securities are sold for $150,000 or more does offer a potentially significant breakthrough for the initial capitalization of new business development companies. Yet it is of no help in solving the liquidity needs of an established business development company that seeks to endure indefinitely. Likewise, the recent issuance of a proposed amendment to a Commission rule relating to transactions with portfolio affiliates of investment companies does

nothing to respond to the critical problems imposed by the 1940 Act upon business development companies. No new rules that would significantly relieve the problems of companies like Heizer are in sight.

Thus, it now appears that any relief that Heizer might obtain from the Commission may come too late, if at all, and will achieve little for the economy and the public interest as a whole beyond permitting Heizer itself to stay in business. For these reasons, it now appears necessary to seek legislative relief.

BACKGROUND

At the request of Chairman Bob Eckhardt and Ranking Minority Member James T. Broyhill of the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, a submission entitled "Venture Capital Companies and the Investment Company Act of 1940" (Exhibit I hereto) was prepared on behalf of Heizer. That submission, which was for the record as a supplement to the testimony before the Subcommittee on September 27, 1978, of E.F. Heizer, Jr., Chairman of the Board and President of Heizer Corporation, also was furnished to other interested persons, including Chairman Harold M. Williams of the Securities and Exchange Commission and certain members of the staff of the Commission's Division of Investment Management.

The submission set forth in detail the reasons why business development companies cannot, as a practical matter, operate under the same restrictions that are imposed upon conventional investment companies by the 1940 Act as currently administered. The submission underscored this reality by observing that today there are no true business development companies registered under the

1940 Act; it noted that the few such companies that once tried to operate thereunder have all given up and liquidated or merged into something else. Only business development companies that qualify for exemption from the 1940 Act are currently doing business. Yet, because the initial investors in business development companies understandably insist upon ultimately having a liquid outlet for their investments, or othewise being able to realize on any gains achieved, and because the Act requires a business development company whose securities are publicly traded to register as an investment company, no substantial business development company, including Heizer, can function successfully for more than a few years without becoming subject to the Act.

Such business development companies as do exist have to live within the conditions for exemption set forth in Section 3(c)(1) of the Act. This means that in raising their own capital they must not engage in a public offering of their securities and their shareholders can never exceed 100 in number, including by attribution the shareholders of any corporation that itself holds 10% or more of their shares. These strictures eliminate any hope for liquidity on the part of the security holders of the business development company. Because few, if any, investors are willing to purchase securities with a prospect of prolonged illiquidity, it is necessary for the business development company, at its birth, to plan its own demise.

The unwanted result, then, both for business development companies and for a nation seriously short of the capital needed to nurture its emerging enterprises is this: the 1940 Act as presently applied eliminates the substantial business development

company as a viable long-term entity. Without immediate administrative or legislative relief, the submission concluded, Heizer will be compelled to terminate its operations as the nation's largest independent business development company.

Thus Heizer, on behalf of all entities engaged in furnishing business development capital, has been working with the Commission staff to try to obtain meaningful and predictable relief from the 1940 Act consistent with the protection of investors.

MEETING OF JANUARY 26, 1979

Messrs. McDermott, Garrett, and Dykstra met with Messrs. Mendelsohn, Lybecker, Cimmet, and Bardfeld of the Division of Investment Management in Washington on January 26, 1979. The purpose of the meeting was to discuss in general terms what relief, if any, the staff was prepared to recommend be accorded business development companies in light of the problems described in the submission of December 20, 1978 (Exhibit I hereto).

The staff opened the meeting by stating that they were prepared to consider recommending the adoption of rules that would significantly lessen the impact of the 1940 Act on business development companies. However, they cautioned, any relief recommended will be based on the premise that securities issued by business development companies should not be available for purchase by small investors without the protections of the 1940 Act. The key element of the relief suggested by the staff would provide for a complete exemption from the Act for many business development companies in their start-up stages by means of the adoption of a new rule under Section 3(c)(1) of the 1940 Act. This rule, as contemplated by the staff, would exclude from the computation of

the number of security holders thereunder any person who has paid $150,000 or more for the securities of a defined business development company. In the event that a mutually satisfactory rule along these lines could not be drafted, the staff advised that they would be willing to recommend rules that would relax specific sections of the 1940 Act posing special problems for business development companies

Exemption under Section 3(c)(1) The "150,000 Rule

As envisioned by the staff, any person who has purchased the securities of a defined business development company for $150,000 or more would be excluded from being counted as a beneficial owner under Section 3(c)(1). Moreover, an offering limited to $150,000 purchasers would not be considered a "public offering" thereunder. The $150,000 threshold was selected by analogy to Rule 146 under the 1933 Act, paragraph (g)(2)(d) of which provides that "any person who purchases. . . securities of the issuer in the aggregate amount of $150,000 or more" shall be excluded for purposes of computing the number of purchasers thereunder.

All of those at the meeting agreed that there are some obvious problems with the proposed rule that need to be resolved. In order to assure the continued exclusion of small investors, the staff viewed the $150,000 floor as necessary for both primary offerings by the business development company and for trading in the after-market by its security holders for at least five years following the initial offering. It was noted that the business development company might have to employ some sort of buy-back feature in order to preserve both the exemption and the liquidity needs of its investors during those first five years (when the stock price can fluctuate substantially). Following this five-year

"start-up" period, after-market sales at a price less than $150,000 would not vitiate the exemption so long as the initial price of the unit being traded was at least $150,000. In order to prevent the breaking up of the $150,000 investment into smaller units, the staff suggested that one method might be for each share to be sold for no less than $150,000. In the view of the staff, a floor of $150,000 per unit would provide a reasonably liquid market for business development company securities.

Proposed Exemption for "Established Venture Capital Companies"

Heizer's counsel then furnished the staff with a draft of a proposed statutory exemption for "established venture capital companies" (Exhibit II hereto) which would be a basis for a total exemption without limitation on the size of units traded in the secondary market.* The staff expressed concern that some traditional mutual funds, such as institutional money market funds, might argue that the proposed exemptive rule is, or ought to be, available to them. The problem with the proposed definition, in their view, was that, while a company after several years of operation might well continue to conform to the definition (on the basis of the retrospective character of its investment portfolio), it might in reality be no different from a typical closed-end investment company to the extent that it would no longer be investing in emerging enterprises and actively participating in thier operations. The staff suggested that this problem might be cured by limiting the application of the rule to an invest-

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* The substance of this proposed exemption has been incorporated in Section 6 of H.R. 3991, the "Small Business Investment Incentive Act of 1979," recently introduced by Representative Broyhill and described later in this memorandum.

ment portfolio that consists of no more than a certain percentage of more "mature" companies and that an objective criterion for this kind of maturity could be issuers with securities registred under Section 12 of the 1934 Act. However, this suggestion was rejected by Heizer's counsel for the reason that a number of "adolescent" issuers still in need of business development assistance do in fact have securities registered under Section 12. Further consideration of this problem was promised.

Relaxation of Specific Sections of the 1940 Act

The staff advised that it intends to recommend rule changes that would liberalize certain provisions of the 1940 Act that present special difficulties for business development companies. They stated that the Commission would likely propose rules exempting from Section 17 all transactions involving a registered investment company and an affiliated party if that affiliation resulted solely from the fact that the registered company owns 5% or more of the voting securities of that party (i.e., if the affiliation is solely of a "downstream" nature). The staff indicated that the proposed rules would be designed to be more readable and concise than current Rules 17a-6 and 17d-1(d)(5); among other things, the "financial interest" concept would be relaxed.*

The staff did not endorse the three-tiered exemptive approach for Section 17 suggested by Messrs. Rosenblat and Lybecker in

* A proposed amendment to Rule 17a-6 has just been issued for comment. (Inv. Co. Act Rel. No. 10698 (May 16, 1979)) As discussed later in this memorandum, this proposal would do nothing to relieve the burdens imposed by Section 17(a) on a business development company like Heizer.

law review article,* viz., that an application for exemption under Section 17 would have to be filed only if a transaction subject to Section 17 were not approved by a majority of the disinterested directors or if it were not below a specified de minimis amount. It was noted, however, that the Commission would soon propose a new rule under Section 10(f). Although not directly applicable to business development companies, this proposal, the staff advised, would employ some of these same concepts.

The staff expressed its willingness to consider recommending a relaxation of the prohibitions of Section 18(d) relating to the issuance of options, warrants, rights, and convertibles for business development companies along the lines of Rule 17d-1(d)(4) for Small Business Investment Companies. Recognizing that qualified stock options will evaporate by 1981 by operation of the Internal Revenue Code, the staff requested Heizer's counsel to provide a "skeleton" of a proposed exemptive rule under Section 18(d). Regarding other impediments that Section 18 poses for business development companies, it was suggested that Heizer's counsel likewise draft a proposed exemptive rule; the staff stated that they would be willing to consider going at least as far as Section 18(k), which removes the asset coverage requirement for debt securities issued by SBICs.

The staff expressed little sympathy for the difficulties of business development companies under Section 23(b) (which prohibits the sale of shares at less than net asset value without an

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* Rosenblat and Lybecker, "Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project," 124 U. Pa. L. Rev. 587, 640 and 649 (hereinafter cited as "Rosenblat and Lybecker").

exemptive order or the approval of shareholders). They suggested that any business development company desiring to offer its shares at less than net asset value ought to obtain shareholder approval; it was felt that this approval, subject to appropriate conditions, could be made valid prospectively, perhaps for up to one year.

Additional Information

The staff requested that Heizer submit as soon as possible a summary of each transaction that Heizer had had in the last year or more that would have required an application for exemption from the Act. Later, a list of all of the current investments of Heizer and the market value thereof was also requested. It was agreed that, after this data, together with an outline of the basic elements of a proposed exemptive rule under Section 3(c)(1), had been submitted to the staff, another meeting would be scheduled.

SUBMISSIONS OF FEBRUARY 15, 1979

Letter from John H. McDermott

By letter dated February 15, 1979 (Exhibit III hereto), Mr. McDermott furnished the staff with a list of Heizer's current investments and the fair market value thereof, a description of Heizer's operating procedures (including a discussion of management compensation and Heizer's conflict of interest policies), and an historical description of Heizer's dealings with its principal investee companies.

Mr. McDermott's letter emphasized that, in order for Heizer to function successfully as a business development company, it is compelled to deal regularly with downstream affiliates and with affiliates of those affiliates, some of whom may be upstream affiliates of Heizer. He stressed the enormous difficulty in

Heizer's being able to identify with certainty all of the affiliates of affiliates who might have an indirect financial interest in a transaction to which Heizer is a party. Most important, as Mr. McDermott's letter discussed in detail, a large portion of the transactions that are an essential part of its business would be prohibited by Section 17(a) or Section 17(d) of the 1940 Act if Heizer were a registered investment company. Mr. McDermott's letter thus illustrated with specific examples the impossibility of Heizer's functioning under the 1940 Act without, among other things, significant relief from Section 17.*

Letter from Ray Garrett, Jr. and Attached Rule Proposals

Also by letter dated February 15, 1979 (Exhibit IV hereto), Mr. Garrett furnished the staff with drafts of proposed rules (1) defining a "venture capital company" (Exhibit B to Mr. Garrett's letter) (2) exempting from the computation of the number of security holders under Section 3(c)(1) of the Act persons who purchase securities from a defined venture capi-

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* Some of the transactions described in that letter would have been prohibited by Section 17 (absent a Commission exemptive order) because an officer of Heizer was an affiliate of the investee company by virtue of his ownership of its shares. Heizer has subsequently changed its policy to prohibit such ownership by its officers, so that the effect of the 1940 Act on that class of transactions would not present a current or future problem for Heizer. It would, however, continue to be a problem for some other business development companies who regard this type of investment by their officers as a desirable incentive.

ital company for $150,000 or more in compliance with Rule 146* (Exhibit A), and (3) exempting from all of the provisions of the Act any issuer which has operated as a venture capital company for at least the five prior years and whose investment portfolio meets certain conditions (Exhibit C).

The letter observed that the staff's support for a rule fixing a $150,000 threshold for purposes of Section 3(c)(1) would provide an important boost to business development companies in their start-up stages but would do little to relieve the long-term liquidity problems of investors in business development companies that were discussed in the submission of December 20, 1978. The letter emphasized that, even if some very difficult theoretical problems involved in drafting such a rule could be resolved,** it would be unrealistic as a practical matter to expect that a liquid market for equity securities trading in units of $150,000

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* Some practitioners have stressed that the reference to Rule 146 in this context is not desirable inasmuch as that rule is both exceedingly intricate and non-exclusive. The preferred reference would be "exempt under Section 4(2) of the securities Act of 1933 as not involving a public offering". (See Exhibit B to Exhibit V hereto).

** For example, the letter pointed out, after a few years, how could the issuer ensure that its securities were traded in the after-market at a price in excess of the threshold? What could the issuer do about disposal of its securities by gift, will or pledge? How could a rule be drafted so as to handle acquisitions of securities through the exercise of warrants or conversion privileges, which may be essential to a business development company in its start-up phases? What about stock splits if the trading price of the securities increased dramatically? The suggested controls might be feasible as long as the securities retained the status of restricted securities under the 1933 Act, when all transfers would be barred unless prescribed conditions could be met to the satisfaction of the issuer or its counsel. As a practical matter, though, they would appear to be inconsistent with a status of "free" securities and any degree of active trading.

or more could be sustained. In other words, such a rule would do nothing to relieve the problems presented by the 1940 Act to an established business development company like Heizer.

As a result, the letter took the position that a broader exemption from the 1940 Act is required for business development companies--an exemption that would be conditioned on characteristics that avoid the major aspects of conventional investment companies which led Congress to conclude that investors therein needed the special protections of the 1940 Act. It was stressed that the Commission must weigh the probability of harm that would result from the removal of some of these protections as to business development companies against the economic and social good that would be fostered by the removal.

Accordingly, Mr. Garrett's letter suggested a rule-making approach that would go beyond the staff's proposal for encouraging new and unseasoned companies (the $150,000 rule) by recognizing that, when a business development company becomes "seasoned," the protections of the 1940 Act are not necessary, even for small investors. A key feature of this framework was the suggested definition of "venture capital company." This definition employed substantially the same subjective definition contained in Section 12(e) of the 1940 Act and added the objective criterion that at least 80% of the company's investment portfolio (exclusive of cash equivalents) consist of securities acquired directly from the issuer. The definition, then, would be applicable only to those relatively few entities that are in fact engaged in furnishing needed capital directly to emerging business.

The proposed rule-making approach, however, did not end with this definition. Instead, only a defined venture capital company (i.e., business development company) that (1) was so engaged for at least the five prior years, (2) had a net asset value of at least $10,000,000, and (3) at least 50% of whose portfolio securities had been held for at least the five prior years, would qualify for exemption from the 1940 Act (Exhibit C to his letter). These additional, deliberately narrow, criteria were designed to exclude from the exemption virtually every other investment entity that was not engaged in providing development funds directly to new or developing business. By requiring that the investment portfolio be stable, the suggested rule was intended to insulate small investors from the abuses that can arise from the control of a large pool of liquid capital. In sum, then, the proposed exemptive rule for seasoned business development companies was designed to combine the public interest (by allowing business development companies to continue to operate after their early years by providing their initial investors with liquidity on their investments) with the protection of investors. The same standards could be the basis for an order of exemption.

MEETING OF MARCH 2, 1979

Messrs. McDermott, Garrett and Dykstra met again in Washington with Messrs. Mendelsohn, Lybecker, Cimmet and Bardfeld on March 2, 1979. The discussion focused on two topics: (1) the $150,000 rule and (2) the suggested rules or an order under Section 6(c) that would exempt "seasoned" business development companies from all or some of the provisions of the Act.

Exemption under Section 3(c)(1)

The staff reiterated their support for some form of a $150,000 rule under Section 3(c)(1). Indeed, the staff indicated that they would urge that such a proposed rule or rules be issued for comment as soon as an acceptable definition of venture capital company could be formulated.

The staff were not fully satisfied with Mr. Garrett's suggested definition (Exhibit B to his letter of February 15, 1979). In their view, such a definition ought to concentrate upon the kind of companies in which the business development company invests rather than on the mix of the securities in its portfolio (i.e., privately placed, held for at least five years, etc.). Thus the staff was seeking criteria that would limit the exemption to investment entities that hold the securities of embryonic or adolescent companies. The staff proposed in passing that exchange listing criteria might be used--for example, a business development company would not have the exemption available to it if an investee company, at the time of investment, were eligible for listing on the American Stock Exchange. Similarly, irrespective of the character of the investee company at the time of the investment, suggested the staff, if more than a certain portion of the portfolio consists of the securities of companies no longer in need of development capital, the exemption under the $150,000 would not be available. It was agreed that Heizer's counsel would

address themselves to these concerns of the staff.*

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* There is a natural tendency to intermingle the concepts of venture capital or business development financing with small business financing. While they are not wholly unrelated, there are significant differences that must be borne in mind in determining policy. The distinctive feature in business development financing is the high risk involved because of new technology or new business ideas, in Heizer's case exemplified by Amdahl and Federal Express, respectively. Such financing is not "bankable" in the ordinary sense and requires funds from an entity not only oriented toward risk but also with the skill to recognize promising prospects and contribute to their development. The entities receiving such financing may be small, on an absolute scale, but they may not be. In any event, size is not the governing criterion. The social desirability of helping small businesses because they are small raises different problems and policy considerations. It was not always clear in the discussions that these distinctions were being maintained.

There remains the problem of identifying the type of investment suitable for a business development company in the sense of justifying a special exemption. It is generally agreed that what is new, innovative and developmental and what constitutes contributing to development defy precise definition, and the problem should be addressed in terms of direct and substantial investment. The staff, however, has had the further concern that a company enjoying an exemption as a business development company, if it has had some success with its investments, might "rest on its laurels" and cease to invest further. Or, if it does invest further, it might do so only to put more money into investee companies that are already beyond the development stage. In either event the company would no longer be performing the economic function for which the exemption was granted.

These concerns seem more apparent than real. At some point a successful business development company resting on its laurels or investing only in well-established enterprises could no longer make a bona fide claim that it was "engaged principally in the business of furnishing capital or providing financing for business ventures . . . " nor could it get an opinion from responsible counsel supporting its claim for exemption. Furthermore, once an investee company has become "developed" and its securities are acceptable to more conventional investors, they would cease to be attractive to a business development company as to yield and other terms. These self-corrective elements seem adequate, and reliance upon them seems preferable to any effort to measure suitable investees by age or size or trading market for their securities.

Relief for Seasoned Business Development Companies

Heizer's counsel reiterated to the staff the position that, although the adoption of a $150,000 rule along the foregoing lines might provide a significant boost to some business development companies in their start-up stages, it would do virtually nothing to alleviate the liquidity problems encountered by established business development companies like Heizer. By the end of the meeting, the staff appeared to accept this as fact.

Nonetheless, the staff repeatedly stressed that a generic exemption from the 1940 Act by rule for established business development companies would not be acceptable. Moreover, an exemption from Section 17 alone, the staff emphasized, was not a realistic possibility, for the reason that Section 17 is "the teeth of the statute" and the 1940 Act would be reduced to a nullity were that provision carved out. In the staff's view, small investors in investment companies need the "paternalistic protection" of the 1940 Act to a greater extent than the law provides investors in companies generally, and this is true of business development companies even if "seasoned". The representatives of the Division were unpersuaded by the distinction drawn by counsel between the business risks of an investment, with which the 1940 Act does not deal, and the risks resulting from abuses involving self-dealing and complicated capital structures, with which the 1940 Act does deal but which are far less likely to occur in business development companies than in more typical investment companies with large pools of liquid capital.

The group then explored the possibility of an _ad hoc_ exemption pursuant to an order under Section 6(c) for Heizer and other business development companies similarly situated. Two alternatives were discussed in this connection: an exemption from specific sections of the 1940 Act (which would require registration and was thus preferred by the staff) or a complete exemption from the 1940 Act.

Each of these ideas as addressed by the staff would present significant obstacles to Heizer. In the first case (the partial _ad hoc_ exemption), the staff again insisted that a full exemption from Section 17 is not a realistic possibility in spite of the thrust of Mr. McDermott's letter that Heizer must have significant relief from dealings with both upstream and downstream affiliates. In the staff's view, it would be pointless to require a business development company to register under the Act and then exempt it completely from Section 17. In the second case (a complete exemption from the 1940 Act without registration), the staff noted that the Commission is extremely reluctant to issue _ad hoc_ exemptive orders, preferring instead to issue rules of more general applicability.

In spite of their expressed confidence in the integrity and ability of Heizer's management, the staff demurred as to whether it could agree to support an application for a complete exemption. It was suggested that Heizer's counsel prepare a draft application and attempt to work with the staff in developing conditions of narrow applicability. The staff expressed concern that others, some of whom might not be engaged in furnishing business develop-

ment capital, would argue that the requested relief should also be available to them. Among the conditions for exemption discussed were the adoption and recital of a rigid code of ethics relating to potential conflicts of interest, the prior approval by the full board of directors (including a majority of the disinterested directors) or a committee thereof of any transaction involving such a conflict, a right of inspection by the Commission, and the absence of direct investment participation in the investee companies by the Heizer officers and directors.

In addition, stressed the staff, the kinds of entities whose securities are held in the investment portfolio would have to be narrowly defined so as to limit the number of prospective exemption-seekers. The staff expressed the view that the size of the investment portfolio is not an appropriate criterion because the temptation for self-dealing is unrelated to size. As discussed above, the application instead should attempt to delineate conditions as to the size and character of the investee companies, the circumstances under which more funds could be invested or, conversely, the investment disposed of, and the participation by employees of Heizer in the investee companies. The application thus would contain a relatively brief narrative of the facts, a statement of the need for the exemption, and then a lengthy set of conditions.

Heizer's counsel were advised that, whether Heizer sought a complete or partial exemption, the Commission might on its own motion request a full administrative hearing in order to make a

record. The staff, in turn, were advised that it was likely that Heizer and others in the industry would seek legislative relief at the same time that any administrative solution is pursued. The staff tentatively predicted that, if the legislative relief to be sought would permit the marketing of business development company securities to smaller investors, they might oppose it.

SUBMISSIONS OF APRIL 13, 1979

Letter from Ray Garrett, Jr. and Attached Rule Proposals

By letter dated April 13, 1979 (Exhibit V hereto), Mr. Garrett furnished the staff with drafts of revised proposed rules that would (1) define a "business development company" (Exhibit A to the letter), (2) exempt from the computation of the number of security holders under Section 3(c)(1) of the 1940 Act purchasers of securities of a defined "business development company" in a non-public offering for $150,000 or more (Exhibit B), and (3) exempt established "business development companies" from registration under the 1940 Act subject to certain narrowly prescribed conditions (Exhibit C).*

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* The suggestions, particularly those referred to in clause (3), were an effort to meet the staff's categorical opposition to providing a total exemption for business development companies, without a "$150,000" limitation on secondary trading, by further circumscribing the availability of the exemption with provisions protecting shareholders from Section 17-type of abuses and yet avoiding SEC participation through a need for exemptive orders. The staff had rejected the conditions for such an exemption that had been presented at the January conference (and that appear to provide the basis for the exemption proposed by Mr. Broyhill). Without agreeing that further conditions were necessary as a matter of sound policy, Heizer's counsel were seeking an approach which would provide some significant stimulation to business development financing while meeting the staff's fears regarding investor protection.

The letter concurred with the staff's goal that any definition of business development company be narrowly drawn so as to include only those relatively few entities that are engaged in the socially desirable activity of providing capital to young or developing enterprises and that the exemption not extend to other entities that are not in fact so engaged. It acknowledged the staff's suggestion that one ingredient in the definition might be a size limitation on the investee companies, expressed in terms of ceilings on each investee's tangible net worth, net income, and possibly the market value of its outstanding securities. The letter advised, however, that having explored this idea, Heizer's counsel had concluded that the size of an enterprise, as measured by its current balance sheet or income statement, is simply not a reliable indicator of its maturity, its need for development capital or its access to capital at reasonable cost from other sources. Moreover, counsel had been unable to formulate a definition of business development company using the size concept that would effectively exclude other investment entities that are not significantly engaged in the financing of emerging companies. In spite of the staff's continuing opposition to a total exemption from the 1940 Act in the absence of a limitation on the minimum investment even in the secondary market, the letter reiterated the position that "substantially total exemption is the necessary goal."

Attached as Exhibit A to Mr. Garrett's letter was a newly formulated definition of "business development company." The key feature of the suggested definition was paragraph (b)(4) thereof. This provision would require in substance that, as to at least 80%

of its net assets (exclusive of cash equivalents), a company, in order to come within the definition, must be the beneficial owner of more than 10% of the voting securities of the investee as of the time of the initial investment (on a pro forma basis, after the exercise of all options, warrants, rights and conversion privileges acquired by the business development company).

The stated advantages of the proposed definition were as follows: First, by requiring the entity making the investment to acquire more than 10% of the investee's voting securities at the time of the initial investment, it would virtually assure the active involvement by that entity in the operations of the investee, which (as was stressed in the submission to Congress of December 20, 1978) is a characteristic peculiar to venture capital companies that are engaged in business development. Second, the floor of 10% would preclude, as a practical matter, the acquisition of securities of larger issuers that might not be in need of development capital. Third, the provision would be objective, thereby permitting both the staff and the securities bar readily to determine compliance. Lastly, the proposed definition would be rigidly exclusive--few if any entities other than those that were in fact furnishing capital to young or developing businesses would be able to use it. As an example, the letter noted that the investment policy of virtually every mutual fund or closed-end investment company prohibits it from acquiring more than 10% of the voting securities of any one entity, so that it may qualify for the pass-through tax treatment granted by Subchapter M of the Internal Revenue Code. In order to narrow the

applicability of the proposed definition still further and to assure that needed capital is furnished directly to the emerging enterprise, the earlier suggestion that at least 80% of the net assets of the business development company consist of securities acquired directly from the investee company was retained.

Because the staff was already working on a proposed rule adopting the $150,000 threshold for start-up situations, the discussion of the revised version of this rule was limited to an explanation as to why it should be tied to Section 4(2) of the 1933 Act rather than Rule 146 thereunder.

Perhaps the most significant proposal furnished to the staff with Mr. Garrett's letter was the revised exemptive rule for established business development companies (Exhibit C to the letter). This proposed rule, which was patterned closely after the Commission's proposed Rules 10f-3 and 17e-2, recognized the enhanced role of disinterested directors in safeguarding the interests of shareholders. The rule would be applicable only to that narrow group of issuers meeting the definition of "business development company" and then only to those that have operated continuously as such for at least five years. It would go beyond Section 10(a) of the 1940 Act by requiring that no more than 40% (not 60%) of the business development company's board of directors be interested persons as defined in the Act.

The most significant element of the rule would obligate the disinterested directors to adopt and continously review procedures designed to ensure the protection of investors. The rule would require that these procedures flatly prohibit <u>any</u> transaction

between the business development company and any of its directors, officers, employees, partners, co-partners, or any affiliates of any such persons if the transaction would violate Section 10(f) or Section 17(a) or (d) of the 1940 Act (except as otherwise permitted by the Commission's rules), assuming the business development company were a registered investment company. The proposed rule also would condition the exemption upon the adoption of a procedure designed to prohibit any transaction between the business development company and any person controlling it.

Most important, the rule would prevent <u>any</u> other transaction that would be prohibited by <u>any</u> provision of the 1940 Act unless a majority of the business development company's disinterested directors, or a committee thereof, had rendered its prior approval of the transaction. This portion of the proposed rule, then, would extend not only to transactions prohibited by Section 10 or Section 17, but to the entire 1940 Act, including Sections 18, 22, and 23. Consistent with the increased reliance that the Commission is placing upon an issuer's disinterested directors to ensure investor protection, these directors would be responsible for determining in advance that every transaction entered into by the business development company that would otherwise require an exemptive order under the 1940 Act was fair and reasonable to the shareholders, was in their best interests, and did not involve overreaching of the business development company or its shareholders. In the words of the letter, "[w]e are confident that such a format would achieve the full measure of investor protection required by the Act."

As added protection for the shareholders, the proposed rule would require that the business development company's independent public accountants be selected and approved by both its disinterested directors and its shareholders. Further, an independent appraiser, who would opine annually upon the portfolio valuation, would be selected and approved by the disinterested directors and the shareholders.

The letter concluded that the effect of these procedures "would be to provide investors in business development companies with real protections against self-dealing and unsound capital structures while at the same time according these entities at least a neutral environment in which to function in the public interest." If the Commission felt it necessary to oversee the continued vitality of the exemption, the letter suggested that it could be "perfected" by an initial filing, coupled with periodic reports by the business development company claiming the exemption (somewhat after the fashion of Rule 2 under the Public Utility Holding Company Act of 1935) and rights of inspection by the Commission.

Letter from John H. McDermott

Also by letter dated April 13, 1979 (Exhibit VI hereto), Mr. McDermott furnished the staff with a draft application in summary form for an exemption for Heizer under Section 6(c) of the 1940 Act. The draft contained as conditions to the requested exemption substantially the same prohibitions and procedures described in Mr. Garrett's letter.

MEETING OF APRIL 20, 1979

On April 20, 1979, Messrs. McDermott, Garrett and Dykstra met once again with Messrs. Mendelsohn, Lybecker, Cimmet and Bardfeld of the SEC's Division of Investment Management. Mr. Gene A. Gohlke of the Division also was present.

Overview

The staff opened the meeting by abandoning their position, expressed at the meeting of March 2, that they were interested in considering relief chiefly by rule rather than by order so as to avoid the creation of more occasions for administrative proceedings. Because of the "radical nature" of the relief requested by Heizer, the staff advised that it would not be obtainable by rule but only by means of an ad hoc application for exemption filed by Heizer under Section 6(c) of the 1940 Act. The staff reiterated the possibility that others, in commenting upon a proposed exemptive rule relating to business development companies, would inevitably argue that it ought to be available to them as well. Indeed, the staff stated they would prefer that any exemptive relief that would be broadly applicable to defined business development companies be accorded by legislation rather than by rule-making. For this reason, the remainder of the meeting focused upon the contents of Heizer's proposed application for exemption under Section 6(c).

The staff emphasized on several occasions during the meeting that the relief to be sought by Heizer in its application would be

55-753 O - 80 - 21

"revolutionary."* Accordingly, the staff's position was that the Commission should not grant any order pursuant to the application except following a formal administrative hearing with a full record of the proceedings. It was later estimated by the staff that such a process might take eighteen months or more.

Specific Factual Questions of the Staff

The staff then raised several questions concerning Heizer and its operations. They first asked what the tax consequences would be to Heizer shareholders if Heizer were to sell a large portfolio holding. Heizer's counsel replied that Heizer as a corporation would have a capital gain or a capital loss, but that Heizer shareholders would have no immediate tax consequences. The staff then inquired as to what the tax consequences would be to Heizer shareholders if Heizer were to distribute the proceeds of a portfolio sale to them. The response was that the tax consequences to Heizer shareholders would normally be either ordinary income or a return of capital (depending upon the status of Heizer's "earnings

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* How revolutionary it would be for the Commission to exempt business development companies depends upon where analysis begins. It if begins with the assumption that a business development company is obviously and completely an investment company, like any other closed-end company, and thus bearing all of the dangers of investor abuse that led Congress to impose the special regulatory burdens of the 1940 Act, then "revolutionary" may be an appropriate characterization. But if analysis begins with a recognition that a business development company is "just barely" an investment company, caught on the wrong side of the line in the statute's effort to separate investment companies from all other companies but possessing few if any of the opportunities for abuse, beyond those present in non-investment companies, then the proposed exemption is not revolutionary at all. Rather it would constitute a recognition by the Commission that its 1940 Act jurisdiction over such a company is more technical than substantive and that a reasonable accommodation is appropriate.

and profits" accounts). It was emphasized that Heizer, because it does not qualify under Subchapter M of the Internal Revenue Code, is not able to avail itself of the pass-through treatment available to regulated investment companies that qualify thereunder.

The staff then suggested that, if the exemption requested by Heizer were granted, there would not be an immediate flow of new business development capital for the reason that the only direct effect of the exemption would be to permit Heizer shareholders to sell their shares in the secondary market. However, the staff continued, if Heizer were compelled to "self-destruct" because it could not obtain the exemption, the present Heizer management could start a new business development entity, so that there would be an almost immediate flow of new capital. Heizer's counsel made two initial responses to these observations. First, it was pointed out that in the event of a secondary offering by Heizer shareholders, there would be a strong possibility of a primary offering by Heizer as well that would raise additional funds for immediate infusion into emerging business. Second, counsel noted that it would take a company like Heizer approximately two to four years to liquidate and dissolve, so that, if the exemption were not granted, it would take at least that period of time for Heizer to begin a new business. It was pointed out that a business development company typically takes up to five years to be fully invested. Counsel also observed that it simply may not be feasible or personally desirable for Heizer and its current management to begin a new business development operation. As a result, Heizer might well

terminate its operations altogether if meaningful relief is not obtainable in the reasonably near future.

The staff then continued with their questions. In the staff's view, if Heizer shares were publicly traded, they would likely sell at a premium over net asset value because of the great recent success of Heizer. Yet, noted the staff, Heizer's portfolio companies are, to a large extent, mature or almost mature and thus would not grow at the rate they had previously. Therefore, it is possible that public investors might be disappointed after a few months because of the slowed rate of growth of the portfolio companies; as a result, the Heizer shares might then sell in the open market at a discount from net asset value. On the other hand, if Heizer were to sell off some of its more mature investments prior to a public offering, then the public investors would have the same opportunity to realize the rapid growth upon the reinvested proceeds as did the early investors. The problem with this to the staff, however, is that these public investors would be subject to risks that are not really characteristic of an established business development company but instead more typical of an incipient business development company. The staff repeated their often expressed concern that small investors should not be involved in venture capital risks.

Heizer's counsel responded that the maturity of the portfolio companies is more a matter for disclosure under the 1933 Act than it is a problem under the 1940 Act. Moreover, as a practical matter, investors would more likely be buying the skill of the Heizer management than they would be buying the existing Heizer portfolio. Counsel also reminded the staff that an established business devel-

opment company normally would have a diversified portfolio of investments in companies in various stages of development and that an individual's investment in such a business development company would be considerably less hazardous than an investment in a premature public offering of a single comparable portfolio company. Counsel noted that Heizer has suspended making any new investments pending a resolution of the current liquidity problems of its shareholders.

Details of the Heizer Draft Application for Exemption

The staff then reviewed some specific details of Heizer's draft application for exemption and the conditions therein. A significant problem in the application for the staff concerned Heizer's request for a blanket exemption from the 1940 Act. It was recalled that, when The First National Bank of Chicago attempted to obtain a similar blanket exemption in connection with its attempt to pool credit union investments, the Investment Company Institute ultimately objected, thereby causing the Commission to request that the Bank catalog in detail why it could not live within each section of the 1940 Act. The Bank decided that this request was too onerous and withdrew its application. The staff suggested that, if Heizer intended to persist in its attempt to obtain an exemption from the entire 1940 Act, it should likewise be prepared to specify why it cannot exist without relief from each of the specific provisions of that Act.

The representatives of the Division then raised the problem of what would happen in the event that Heizer or its directors failed

to comply, either deliberately or inadvertently, with the conditions of its application for exemption. The staff noted that, in the Puerto Rico Capital case, the directors were duped by not knowing that the company was doing business with an affiliate. Heizer's counsel, while pointing out that this problem could happen whether a company is registered or not, agreed to try to formulate procedures whereby the Division would be able to intervene in the event of systematic noncompliance by the exempt company if Heizer were to seek and obtain an order of total exemption. These procedures would necessarily involve a right of supervision and inspection by the Division and likewise would include a reporting procedure by Heizer.

Heizer's counsel were requested to consider whether Heizer would be willing to undertake that, in the event that a violation were later discovered by the disinterested directors, it would agree to make restitution. The staff also suggested that Heizer undertake that the Commission would have the same enforcement powers that it would have were Heizer registered as an investment company.

The staff then focused on the condition that, as to at least 80% of Heizer's net assets (exclusive of cash equivalents), Heizer would hold at least 10% of the outstanding voting securities of the portfolio company, assuming the exercise of all of its outstanding options, rights and warrants. In particular, the staff questioned whether the 10% holding would have to persist in order for Heizer to continue to be exempt. Counsel replied that this condition would apply only at the time of the initial investment;

even so, this requirement would exclude virtually every other investment entity because of the terms of Subchapter M. The staff asked Heizer nonetheless to explore some sort of a continuing 10% requirement--e.g., as to at least 80% of its net assets, Heizer would have to own at least 10% of the outstanding and pro forma voting securities of its portfolio companies on a weighted average basis.

The staff then questioned the exclusion in both the proposed rule and the draft application of cash equivalents and suggested that this exclusion be only temporary, along the lines of the proposed revisions of Section 3(c) and Section 3(a)(3) of the 1940 Act under the Federal Securities Code (presumably proposed Section 281(c) of the Code). It was agreed that this suggestion would be explored and that consideration would be given to revising the cash equivalents language so as to make it apply only to temporary investments.

General

The staff reconfirmed that they were going ahead on the $150,000 start-up exemption for defined venture capital companies. Counsel were advised that from then on Heizer's negotiations should be solely through Mr. Lybecker and the staff, with Mr. Mendelsohn's retaining a supervisory role in the proceedings. The staff stressed that, in their view, Heizer would be required in the administrative hearing to show justification for an exemption on a section-by-section basis.

SUBSEQUENT DEVELOPMENTS

Discussion of May 1, 1979, with Mr. Lybecker

On May 1, 1979, Mr. Dykstra advised Mr. Lybecker by telephone that Heizer tentatively and reluctantly had determined that it would not seek from the Commission a blanket exemption from the 1940 Act but instead was prepared to contemplate registration as an investment company, provided that it could obtain meaningful and concurrent relief from Sections 17 and 18, together with favorable interpretations of Sections 2(a)(41) and 23(b). This approach of obtaining selective relief from specific provisions of the 1940 Act as a registered company, suggested Mr. Dykstra, might expedite the negotiations by removing the staff's supervisory and enforcement problems over an unregistered company as delineated at the meeting of April 20. Mr. Lybecker was advised that the relief to be sought by Heizer from Section 17 would be substantially the same as that urged in Mr. Garrett's letter of April 13.

A meeting to discuss these matters was scheduled to be held with the staff in Washington on May 21. It was agreed that the meeting would focus almost exclusively on the staff's position regarding Heizer's request for relief from Section 17 for the reason that, if an accord on this provision could not be reached, it would be pointless to go further. If, on the other hand, substantial agreement on Section 17 were reached, it would seem likely that a resolution of the problems under Section 18 could likewise be obtained.

The Small Business Investment Incentive Act of 1979

On May 8, 1979, Representative James T. Broyhill of North Carolina introduced H.R. 3991, entitled the "Small Business Investment Incentive Act of 1979" (Exhibit VII hereto). Section 6 of this bill would exempt completely from the 1940 Act any issuer principally engaged in the furnishing of capital "for business ventures and activities" provided that at least 80% at cost of the securities (exclusive of cash equivalents) held by the issuer consists of securities acquired directly from the investee company. It is noteworthy that this provision is substantially equivalent to the proposed exemptive rule (Exhibit II hereto) submitted by Heizer's counsel at the meeting of January 26, 1979.

Issuance of Proposed Amendment of Rule 17a-6

On May 16, 1979, the Commission issued for comment a proposed amendment to Rule 17a-6 under the 1940 Act. (Inv. Co. Act Rel. No. 10698.) Rule 17a-6(a), as now in effect, provides in substance that a transaction between a business development company (or a Small Business Investment Company) and one of its affiliates (or an affiliate of that affiliate) is exempt from the prohibitions of Section 17(a) of the 1940 Act (which bars virtually all dealings between a registered investment company and its affiliates). But this exemption is available only if none of six enumerated classes of persons is, or has a financial interest in, a party to the transaction.

Although 17a-6(a) appears to have been intended to facilitate dealings between a business development company and its downstream affiliates (sometimes called "portfolio affiliates"), it did not represent much of a concession even when it was adopted in 1961.

It is hard to imagine in the first place how a downstream affiliate (a party controlled or influenced by the investment company) could be in a position to deal with the investment company to the detriment of the shareholders of the investment company. Indeed, the statutory prohibition on dealings with downstream affiliates "does not appear to have been anticipated or intended"* by the draftsmen of the 1940 Act.

Even so, as discussed in the submission of December 20, 1978 (Exhibit I hereto), existing Rule 17a-6(a) is so vague and prolix as to be of little practical value. For example, although the availability of the exemption is critically dependent upon the meaning of the term "financial interest," that term is left conspicuously undefined in the Rule, the Act or anywhere else. This "financial interest" concept is not even moderated by a de minimis standard. What is worse for business development companies (assuming any were registered under the 1940 Act), existing Rule 17a-6(a), with its list of six classes of prohibited persons or affiliates thereof, continues to leave virtually all transactions of business development companies (which regularly must deal with affiliates as an essential part of their business) in potential violation of the 1940 Act. A prime reason for this, as Mr. McDermott stressed in his letter of February 15, 1979 (Exhibit III hereto), is that it is almost impossible for a business development company like Heizer to identify all of its affiliates (and affiliates of affiliates) and all "financial interests" thereof. Businessmen are under-

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* Rosenblat and Lybecker at 653.

standably reluctant to enter into transactions when they cannot readily determine whether those transactions are permissible

The Commission's recent proposed amendment to Rule 17a-6 would permit any registered investment company (not just a business development company or an SBIC) to deal with a "portfolio affiliate", provided none of the same parties enumerated in paragraph (a) of the existing Rule is a party to, or has a "financial interest" in, the transaction. This would be a modest extension of the exemption accorded to all registered investment companies in paragraph (b) of Rule 17a-6, but it would do nothing for business development companies. Only the elimination or substantial modification of the conditions regarding financial interests of affiliates would provide significant relief. In sum, the Commission's proposal is a major disappointment to Heizer.

CURRENT STATUS OF HEIZER

To recapitulate, Heizer must obtain liquidity for its initial investors in the near future or it will have to terminate its operations as the nation's largest independent business development company. Yet investor liquidity requires registration as an investment company, and the Investment Company Act of 1940 as currently applied (especially Sections 17 and 18) is incompatible with the successful operation of a business development company. Thus, without meaningful and swift relief from that Act, Heizer, like others before it, might well have to close its doors. While that result would be unpleasant for Heizer, it would be much more unfortunate for a country already seriously short of the development capital needed to nurture its emerging businesses.

Heizer, to be sure, is encouraged by the SEC staff's willingness to propose a rule designed to relieve the burdens of the 1940 Act on business development companies in their start-up stages. Such a rule, however, is of no direct benefit to an established business development company like Heizer. Although the staff has demonstrated a desire to cooperate in searching for meaningful relief from the problems of established business development companies, Heizer, in truth, is not measurably closer to a solution to its problems within the SEC than when it began its effort in September of 1978.

Moreover, even if the needed relief is ultimately granted, the staff's recent insistence on a formal administrative hearing will almost certainly result in a delay that is unacceptable to Heizer's investors. Perhaps worse, it is likely that any order resulting from such a hearing would be so closely tied to Heizer's particular factual setting that it would be of little predictive value (or encouragement) to other business development companies. Such a hearing, of course, probably also would require very substantial additional outlays by Heizer for legal fees. Under these circumstances, an administrative hearing may not be a viable alternative for Heizer.

In sum, it appears essential to Heizer and desirable to the business development community in general that, if the Commission intends to grant relief from the 1940 Act, it do so in the reasonably near future by rule and not by means of an order following a lengthy administrative proceeding.

GARDNER, CARTON & DOUGLAS

May 18, 1979

EXHIBIT I

VENTURE CAPITAL COMPANIES

AND

THE INVESTMENT COMPANY ACT OF 1940

GARDNER, CARTON & DOUGLAS
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Of Counsel

December 20, 1978

Introduction

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

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

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

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

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

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

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

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

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

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

The Investment Company Act of 1940

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

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

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

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

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

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

5 _Id_. at 594.

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

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

Venture Capital Companies and the Legislative History

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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8 SEC Report at 369.

9 *Id.*

10 Rosenblat & Lybecker at 598.

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

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

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

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

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

On the other side of the coin, though, as we will also show, no substantial venture capital company can function successfully for more than a few years _without_ becoming subject to the Act. Thus the reality, both for venture capital companies and for a nation seriously short of the capital needed to nurture its emerging enterprises,[13] is this: the Investment Company Act of 1940 as presently applied eliminates the venture capital company as a viable long-term form of business organization.

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

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

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

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

Definition of an "Investment Company"

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

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

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

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

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

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

To be sure, Section 3(b)(2) provides for exceptions from the definition of an "investment company" by Commission order, but this requires a finding that the venture capital company is "primarily engaged" in some business "other than investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of business."

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

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

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

Exemption from the Act under Section 6(c)

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

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

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

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

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

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

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

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

19 See text at and following note 7 above.

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

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20 See note 13 above.

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

22 See text following notes 40 and 47 below.

Operation of a Venture Capital Company Outside of the Act

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

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

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

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

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

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

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

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

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

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

The Act as a Minefield

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

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

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

and so amorphous that it defies comprehension by virtually anyone.

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

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

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

28 Id. at 283.

29 Id. at 262.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Application of Section 17(a) to Venture Capital Companies

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 17(d) makes it

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

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

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

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

55-753 O - 80 - 24

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

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

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

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

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

Application of Section 17(d) to Venture Capital Companies

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Obtaining Exemptions from Section 17

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

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

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

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

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

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

52 Rosenblat & Lybecker at 639.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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55 Section 18(d) provides as follows:

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

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

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

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

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

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

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

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

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

Section 18(a): Limitations on Senior Securities

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

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

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60 Section 18(a) provides in part:

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

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

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

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

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

62 These subsections apply to senior securities that represent indebtedness.

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

63 Section 18(c) provides:

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

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

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

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

Other Impediments under the Act

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

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

Conclusion

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

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

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

SIGNIFICANT PUBLIC ISSUES OF VENTURE CAPITAL COMPANIES SINCE WORLD WAR II

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

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

EXHIBIT A

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

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

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

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

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

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

* Went public as licensed SBIC

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

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

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

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

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

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

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

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

HEIZER CORPORATION

AND

THE INVESTMENT COMPANY ACT OF 1940*

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

Background

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

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

EXHIBIT B

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

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

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

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

Transactions with Affiliates

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

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

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

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

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

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

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

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

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

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

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

* * *

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

Capital Structure

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

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

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

Compensation of Key Personnel

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

Change in Investment Company Classification

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

Dividends

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

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

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

Sale and Repurchase of Heizer Securities

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

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

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

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

Administration

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

HEIZER CORPORATION

INVESTORS

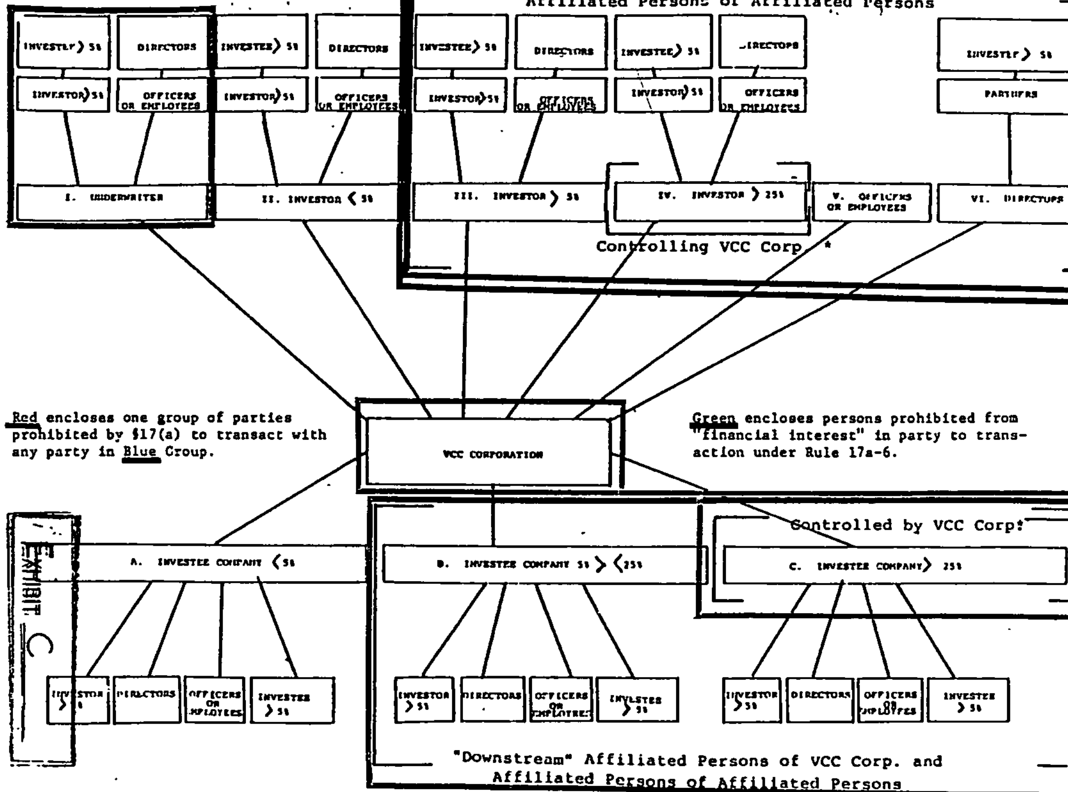
Investor	Location
The American Museum of Natural History	New York, New York
The Art Institute of Chicago	Chicago, Illinois
Bankers Trust Company	New York, New York
Robert R. Barker & Co.	New York, New York
William Blair & Co.	Chicago, Illinois
William A. M. Burden & Company	New York, New York
Citibank,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

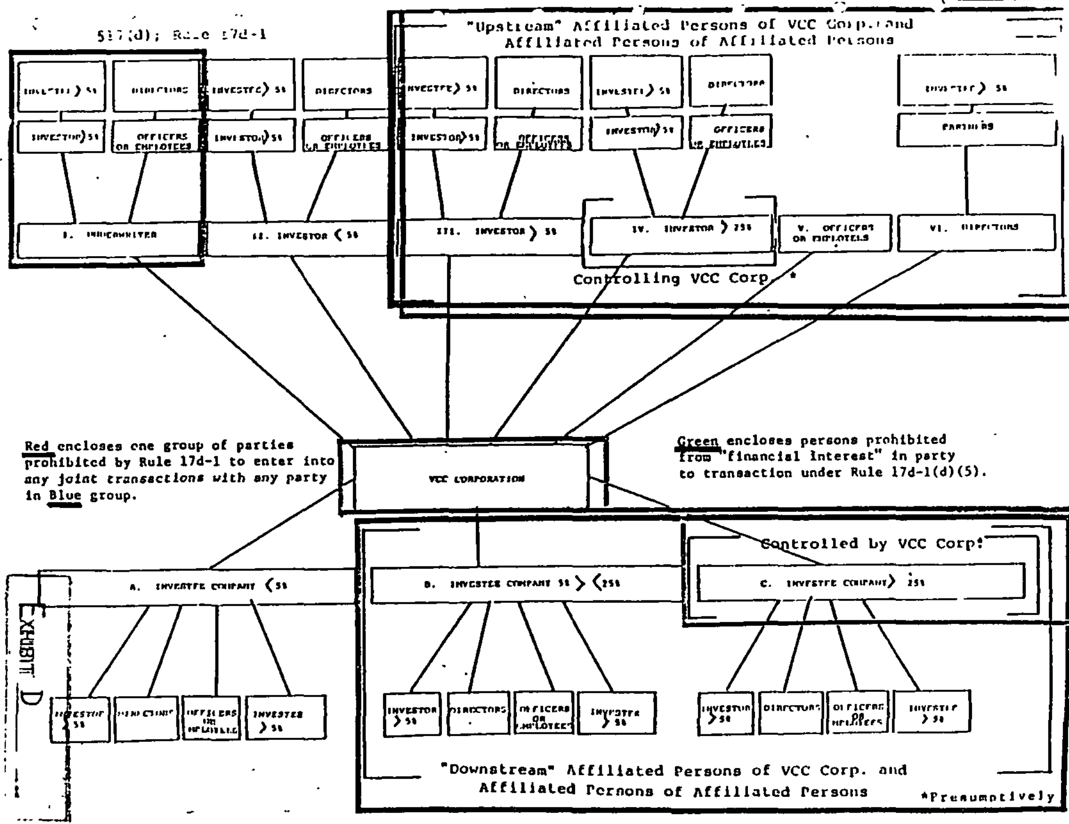
HEIZER CORPORATION HEIZER CAPITAL CORPORATION*

COMPANIES FINANCED

AS OF 6/30/78

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


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



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

EXHIBIT II

DRAFT: 12/13/78

Proposed addition to Section 3(c)(3) of the Investment Company Act of 1940:

(3) . . .; any issuer engaged or proposing to engage principally in the business of furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities; provided, that at least 60% in cost of the securities held by such issuer (exclusive of government securities short term paper and other cash items) consists of (a) securities acquired directly from the issuer thereof in a transaction or transactions not registered under the Securities Act of 1933 or pursuant to the exercise of options, warrants or rights acquired in such transactions, (b) securities received in exchange therefor in a reorganization described in Sections 368 or 371 of the Internal Revenue Code of 1954, as amended, or in any exchange offer, and (c) securities distributed on or with respect to any such securities.

EXHIBIT III

McDERMOTT, WILL & EMERY
111 WEST MONROE STREET
CHICAGO, ILLINOIS 60603
312-372-2000

CABLE ADDRESS
"MILAM"
TELEX NUMBER
25-3565

MIAMI OFFICE
700 BRICKELL AVENUE
MIAMI, FLORIDA 33131
305-358-6030

February 15, 1979

Mr. Sydney H. Mendelsohn
Director, Division of Investment
Management
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Re: Heizer Corporation

Dear Mr. Mendelsohn:

At our meeting in your office on January 31, you asked for information concerning the current value of Heizer Corporation's investments, the manner in which Heizer's officers and directors are compensated and a list of actual transactions involving Heizer which would or might have required approval by the Commission under Section 17 of the Investment Company Act of 1940 if Heizer had been a registered investment company. (References herein to Heizer include its wholly owned SBIC subsidiary, Heizer Capital Corporation.)

Investment Values

Enclosed is a schedule showing both the cost and fair value of Heizer's investments as of June 30, 1978 (Heizer's fiscal year end) and December 31, 1978. Each year in connection with the audit of Heizer's financial statements by Arthur Andersen & Co., Heizer obtains a report from independent appraisers, Duff and Phelps, Inc., as to the reasonableness of the investment valuations. A copy of the Duff and Phelps 1978 report is also enclosed.

Management Compensation

Heizer's officers and directors are compensated in various ways, all designed to highly motivate the individual involved while assuring a common interest with its investors.

Heizer was organized to provide a mechanism for institutions and others to invest in the venture capital field. Most institutions have great difficulty making venture capital investments directly. Part of this difficulty arises from the

fact that an equity oriented venture capitalist must have many of the skills of an entrepreneur (i.e., he must be able to think and act like an entrepreneur). In addition, he must be highly motivated (which usually translates into being highly compensated either currently or prospectively) to be willing to work under the unusual pressures and spend the extraordinary number of hours involved in finding and successfully developing new and unproven companies into profitable enterprises. An entrepreneur who attempts to organize and build a substantial new company undertakes an enormous task which involves considerable risk and a major personal commitment of his time, skills and other resources. For an equity oriented venture capitalist to be successful requires that he assume similar risks and a similar personal commitment. Most institutions are unwilling to make exceptions to their established compensation structure, staffing and other corporate policies necessary to attract the kind of individuals needed to work in the venture capital field.

Heizer's conflict of interest policies are designed to assure continuity of interest between management and Heizer's investors. These policies are very broad and have been in existence for many years. They prohibit Heizer's officers and directors from taking any action or getting involved in any situation which conflicts or might conflict with the interests of the corporation. Specifically, they restrict all transactions in securities of companies in which Heizer is considering or has made investments, transactions based upon or disclosure of confidential information, trading transactions, employment or association with or employing people from companies in which Heizer is considering or has made investments, acceptance of favors or gratuities, and direct or indirect participation in reciprocal arrangements. They require that each officer and director enter into a professional agreement covering the spirit and the letter of the policy and report quarterly or on a more frequent basis any deviations. No deviations are permitted except with approval of the whole Board of Directors. Although not required to do so by law, Heizer distributes in connection with its annual meeting a complete proxy statement disclosing all known conflicts of interest including potential conflicts of interest. The selection of Heizer's auditors, appraisers and outside corporate counsel is submitted for approval of the investors annually, and outside corporate counsel performs a legal review each year of these and other matters.

To conduct its business, Heizer believes that it is essential that principal members of its staff have a significant personal financial interest in Heizer and its investees and that such financial interest be acquired, maintained and

disposed of only in accordance with Heizer's policies. Heizer's compensation package consists of three basic elements: (1) salary, regular bonuses and normal fringe benefits, all designed to be competitive with what the individual could earn elsewhere; (2) ownership of Heizer stock (ten percent of Heizer's common stock is reserved for management); and (3) some form of investment participation or bonus award tied directly to the performance of investee companies. The mix between these elements depends upon the individual's role in the organization. For example, members of the Board of Directors receive customary directors' fees for meetings and committee work and all of them own or have options to buy Heizer stock. Currently, E. F. Heizer, Jr., who is Chairman and President, receives a salary, participates in a bonus pool and is the largest individual stockholder. Other officers and employees are compensated on a similar basis. In many cases, their Heizer stock is in the form of stock options.

From the beginning, Heizer has offered investment participations to officers working directly on the development of an investee company. The form of the participations varied from time to time but essentially they were designed to give the officer(s) working with a particular investee company an interest (on the same basis that Heizer acquired its interest) of up to 1% in the aggregate of Heizer's investment in that company. The participations were structured so that they would continue to be parallel to Heizer's investment and the officers effectively were required to purchase, hold, sell or otherwise deal with their participation in the same way Heizer deals with its share of the investment. The officers also were required to pay their pro rata share of direct expenses incurred in connection with the investment. Since very few of Heizer's officers could afford to buy the participations outright, they were financed by Heizer in exchange for the officer's notes. Upon termination of employment, the officers were required to satisfy their notes and frequently sold their participations and their Heizer stock to Heizer at their then fair value.

In 1977, after a careful study by McKinsey & Co., the framework for establishing an annual bonus pool was developed, tied 50% to Heizer's performance as an operating company (i.e., considering growth in Heizer's share of pre-tax earnings of its investee companies) and 50% to its performance relative to selected growth stock funds (i.e., considering year to year changes in the value of its investments). The bonus pool was established to supplement investment participations which had become a less significant part of the compensation package because Heizer had stopped making new deals. The discontinuance of new deals was necessary in order to permit continued

financing of existing investees and to provide for the anticipated liquidity requirements of Heizer's own investors with respect to their investments in Heizer.

Section 17 Problems:
Determination of Affiliates

A threshold problem in discussing the application of Section 17 to Heizer if it had been a registered investment company is to determine who are its affiliates. Looking downstream, the first-tier of affiliates (principally investees in which Heizer has more than a 5% stock interest) is fairly easy to determine if Heizer's stock interests are considered on a pro forma basis (i.e., assuming exercise of all presently exercisable warrants, conversion rights, etc.).

The most important time for determining affiliate or non-affiliate status is when a transaction by Heizer with an investee is proposed. For a number of reasons, including the inability or unwillingness of entrepreneurs managing investee companies and others financing these companies to plan ahead or admit their need for the venture capital, it is common practice in the venture capital field for transactions subsequent to the initial transaction between a venture capitalist and an investee to be completed within very short time frames (measured by hours or days) and frequently in a crisis atmosphere. The investee is usually out of money and past due on existing obligations. The investee knows that Heizer can exercise its warrants or conversion rights at any time and therefore, in thinking about Heizer's voting power, considers the securities which Heizer holds as if they were exercised. In view of the decision in Midland Capital Corp. and Thomas E. Connett (SEC 1974) '73-'74 CCH Dec. ¶79,813, and the fact that Heizer's ability to influence the management and policies of an investee increases considerably when the investee is in that situation, we have for purposes of this letter considered Heizer's stock interests on a pro forma basis in determining its first-tier downstream affiliates. First-tier downstream affiliates based upon pro forma stock ownership were identified in the list of companies financed attached to our memorandum, Exhibit B to the submission on Venture Capital Companies and The Investment Company Act of 1940 dated December 20, 1978. In most cases, Heizer also is in a position to know the identity of its second-tier downstream affiliates.

Our earlier memorandum identified eight corporate investors who could be deemed to be first-tier upstream affiliates based upon their ownership of Heizer stock (Citibank, Bankers Trust, St. Paul Companies, University of Rochester, Manufacturers Hanover, Employers Mutual, First National Bank of Minneapolis and Robert Barker/Wm. A.M. Burden Company) and three other investors who, depending upon when outstanding

warrants are exercised, could be deemed to be affiliates based upon their stock ownership (Northwestern University, Northwestern Mutual and Prudential). For purposes of this letter we have assumed that all of these investors are first-tier upstream affiliates of Heizer. Although Heizer could probably identify those second-tier upstream affiliates resulting from the affiliation of its directors, officers and employees, it is practically impossible for Heizer to identify its second-tier upstream affiliates resulting from the affiliation of the institutions named above. When several of Heizer's major investors were questions about the number of companies (public or private) in which they held a 5% stock interest, they did not know the answer immediately but estimated that the number was quite large.

With this background, the problems which Heizer would have encountered if it had been a registered investment company as a result of actual transactions which would or might have required advance approval by the Commission under Section 17 of the Investment Company Act of 1940 may be illustrated by the following history:

Amdahl Corporation

Amdahl Corporation has been one of the most successful new business ventures in American history. Founded in 1970 (with assistance from Heizer) by Dr. Gene Amdahl, who left IBM with the goal of producing more powerful computers to be competitive with IBM, Amdahl in 1975 successfully introduced a new generation of large scale computers to the marketplace. Revenues and net income for the year 1978 were $320,900,000 and $48,200,000, respectively. Currently, Amdahl provides jobs for 2,950 employees and pays federal and state income taxes at an annual rate of over $35,000,000.

Approximately $50 million was invested in Amdahl before its first computer was installed. Over a period of five years, Heizer invested $11.2 million of this amount. Heizer's investment at December 31, 1978 was valued at $146.1 million. Amdahl's existence today results in large measure, if not entirely, from the fact that Heizer and others who had confidence in Heizer's judgment, ability and perseverance led the financing of Amdahl, particularly in the early rounds when equity capital was desperately needed and was practically unobtainable from any source.

The first round of outside financing for Amdahl was provided by Heizer starting in 1970. In a series of takedowns over a period of about one year, Heizer purchased $2.0 million of Amdahl's preferred stock with warrants. In late 1971, Heizer purchased an additional $500,000 of this stock. On a pro forma

basis, with its first purchase, Heizer immediately became an "affiliate" of Amdahl and also acquired "control". With each transaction, certain officers of Heizer whose duties were to assist in Amdahl's development acquired investment participations in Heizer's investment.

By 1972, Amdahl was out of money again. Despite Amdahl's efforts with help from Heizer, equity venture capital in significant amounts could not be located for a company such as Amdahl which was in an early stage of development. Knowing that it could not supply all of Amdahl's capital requirements itself, Heizer attempted at its annual meeting to interest its own investor group in financing Amdahl. Most of Heizer's investors declined. A Japanese computer company (Fujitsu Limited) which was not an investor in Heizer, however, was very interested and committed through its wholly owned California subsidiary to invest $5.0 million on certain conditions including establishment at a later date of a joint venture concerning development, manufacture and sale of computers for international markets outside of Japan and North America. Fujitsu also became an "affiliate" of Amdahl. In late 1972, Amdahl also successfully placed $7.2 million of senior convertible subordinated notes with U.S. investors, including Heizer for $2.5 million and, with Heizer's approval, three Heizer investors (one of whom was a director of Heizer, the second was a Heizer affiliate by reason of stock ownership and the third was not an affiliate) for a total of $2.6 million. A German computer company (Nixdorf Computer AG) purchased $6.0 million of Amdahl common stock and became an affiliate. At that time, it was planned that Nixdorf would also become a joint venturer with Amdahl for manufacture and marketing of Amdahl's computers in Germany. In 1974-1975, more funds were advanced against the ultimate purchase in 1975 by Fujitsu of $11.2 million and by Heizer of $6.2 million of convertible subordinated notes. Substantial additional money and credit were advanced in 1974-1975 by Fujitsu through its purchase of certain of Amdahl's inventories and equipment, payments for development work, deferral on interest payments on loans, manufacturing agreements and numerous other transactions. In 1976, Amdahl was recapitalized and had its first public offering of common stock managed by The First Boston Corporation. (A year later First Boston acted as Heizer's investment banker in connection with an attempted private placement of Heizer Corporation securities and subsequently became an investor in Heizer. Two of the three investment banking firms which assisted Heizer in raising its own capital in 1969 also were members of the Amdahl underwriting syndicate.

Heizer's Chairman and CEO has been a director of Amdahl since 1972 and two other Heizer directors (both of whom were original investors in Heizer) have also been directors of Amdahl since 1974. All three Heizer directors on the Amdahl

Board as well as all other non-management Amdahl directors were granted stock options by Amdahl under an Amdahl stock option program which was designed to attract and retain highly qualified people, including directors. Pursuant to Heizer's conflict of interest policies relating to compensation received by Heizer directors or officers for serving on investee companies' Boards of Directors, these options were subsequently assigned to Heizer.

Section 17 Problems If Heizer Had Been Registered (partial list):

1. Since Amdahl became a controlled affiliate of Heizer when the first investment was made, subsequent investments by Heizer seem to be prohibited by Section 17(a)(1). Rule 17a-6 would not provide relief because Heizer's officers had a financial interest in Amdahl through their investment participations or otherwise.

2. Financing of investment participations through officer notes appears to violate Section 17(a)(1) with no relief afforded by Rule 17a-6.

3. The officers originally assigned by Heizer to assist in Amdahl's development are no longer with Heizer. In some cases their investment participations and Heizer stock were repurchased by Heizer apparently in violation of Section 17(a)(1) with no relief afforded by Rule 17a-6.

4. Since Fujitsu was an affiliate of Heizer's affiliate (Amdahl), the numerous transactions between Fujitsu and Amdahl appear to violate Sections 17(a)(1) or 17(a)(2) and the joint ventures, actual or planned, between Amdahl and Fujitsu and between Amdahl and Nixdorf appear to be in violation of Section 17(d).

5. The investments in 1972 by two of Heizer investors who were affiliated with it by reason of being a director or by reason of stock ownership appear to violate Section 17(a)(1) and, because of Heizer's conflict of interest policies which in effect require that Heizer's director act in concert with Heizer, also may be prohibited as a joint enterprise under Section 17(d) with respect to Heizer's director.

6. The issuance of Amdahl options to Heizer directors serving on the Amdahl Board appears to violate Section 17(d) with no relief afforded by Rule 17d-1(d)(5). Options issued to the rest of Amdahl's

management (including options issued to representatives of Fujitsu and Nixdorf on the Amdahl Board) also appear to be prohibited. The assignment of options to Heizer may violate 17(a)(1).

7. If First Boston or the investment banking firms which assisted Heizer in raising its own capital were determined to be "principal underwriters" of Heizer, their participation in the Amdahl public offering appears to be prohibited by Section 17(d).

[Note: Heizer believes that everything that was done helped Amdahl and none of the transactions hurt Heizer's investors]

Omex (formerly Precision Instrument Company)

Omex was founded in 1958 to produce precision instrumentation for use in the space program. In the early 1960's the company had a public offering of its stock and was involved in significant research concerning high-density data storage employing laser technology. Prior to Heizer's involvement with the company, it was controlled by Chase Manhattan Capital Corporation ("Chase Capital") both through Chase Capital's stock ownership and as a result of credit arrangements. The company sustained substantial losses in the late 1960's and into the 1970's due to marketing and technical difficulties encountered in introduction of new mass memory technology into the marketplace. By late 1973 the company was out of money and was referred to Heizer for help. Initially Heizer advanced funds on a demand note basis while the main financing terms were being negotiated. In early 1974 Heizer purchased $3.5 million of Omex's subordinated convertible notes entitling Heizer on a pro forma basis to 66% of the common stock. Some of the conditions of Heizer's investment in Omex were that Chase Capital exchange certain Omex notes for common stock, that Omex's real estate be sold and the proceeds used to retire a mortgage held by Chase Capital, that a less ostentatious office be acquired, that new management be installed, and that there be a restructuring of a $1.5 million obligation of Omex to United California Bank in which Chase Manhattan Bank ("Chase Bank") had a 50% participation. Simultaneously, Chase Capital purchased $540,000 of Omex common stock and sold it to the new management in return for their five-year notes. It was also planned that the Omex Board of Directors be reconstituted to consist of two members from Heizer, one member from Chase Capital and two members of Omex management. Two Heizer officers received investment participations in connection with this financing.

In 1975, Omex again was out of money and sought protection under Chapter XI of the Bankruptcy Act in March. Heizer advanced small amounts of money in return for debtors' certificates of indebtedness during April and May to keep Omex alive while trying to encourage Chase Capital and others to become investment partners. These efforts were not successful and the company's plant was closed in May, 1975. A few days later, in the crisis atmosphere which resulted from the shut-down, an oral agreement was reached between Chase Capital and Heizer to be 50/50 partners in the restructuring and continued funding of Omex. As a part of the agreed upon plan, they worked together to restructure United California Bank's loans to Omex (in which Chase Bank had a participation), to achieve an arrangement with Omex's other creditors and to recruit new management. A new president named Charles W. Missler was recruited and the Board of Directors was restructured to consist of a representative of Heizer, a representative of Chase Capital and Missler. In September, 1975 a plan of arrangement and corporate restructuring was effected, and thereafter until 1977 Chase Capital and Heizer continued to finance Omex on an equal basis evidenced by various legal instruments. As a result of the Chase Board of Directors decision not to be in the venture capital business, Chase Capital was caused to discontinue financing Omex in November 1977. Both Heizer and Chase Capital had been in "control" of Omex prior to November 1977 when a further agreement was reached whereby Heizer's equity position was increased and Chase Capital continued to be an affiliate but its representative resigned from the Board of Directors and it ceased to be in control of Omex.

Omex has a long history of success and failure yet many people continue to be extremely interested in its technology. Since November, 1977, Heizer has caused the Chapter XI proceedings to be reopened and has continued to finance Omex on a demand note basis. Heizer has also been instrumental in introducing Omex to Heizer's upstream affiliate, Employers Mutual, which is working to find a method for switching from its present manual record-keeping system to the highly automated and more efficient Omex system. In this regard Employers Mutual has paid fees to Omex for consulting work of approximately $300,000. If the Omex system and software can be developed to meet the needs of Employers Mutual, it is probable that a very substantial business relationship between Omex and Employers Mutual will result. Such a relationship would provide Omex with a significant inroad in supplying its system in the insurance company market and Employers Mutual may wish to share in some way in the fruits of what results from, in part, its efforts. Additionally, Employers Mutual may wish to consider making a much needed direct investment in Omex.

Because of the close relationships established between Heizer and Fujitsu in connection with the development of Amdahl, there have been a number of conversations between

Omex, Heizer and Fujitsu about working together on some sort of joint business arrangement to develop and market the Omex technology. One of Omex's officers has done consulting work for Fujitsu in this regard.

The possibility has been discussed of merging Omex with Computer Consoles, Inc. (another controlled affiliate of Heizer described herein beginning on page 11).

Section 17 Problems If Heizer Had Been Registered (partial list)

1. Since Omex became a controlled affiliate of Heizer when the first investment was made, subsequent investments by Heizer seem to be prohibited by Section 17(a)(1) with no relief afforded by Rule 17a-6 because Heizer's officers had a financial interest in the transactions.

2. The relationship between Omex and Heizer's first-tier upstream affiliate (Employers Mutual) may constitute a joint enterprise and be prohibited under Section 17(d). The same prohibition appears to apply to any arrangement which evolves from the conversations between Omex, Heizer and Fujitsu.

3. A merger of Omex with Computer Consoles appears to violate Section 17(d) with no relief under Rule 17d-1(d)(5) because of the financial interests of Heizer's officers and Heizer's first-tier upstream affiliate (Employers Mutual) and possibly its second-tier affiliate Fujitsu (through Amdahl).

4. Financing of investment participations in Omex through officer notes appear to violate Section 17(a)(1) with no relief afforded by Rule 17a-6.

5. The officers originally assigned by Heizer to work with Omex are no longer with Heizer and have sold their investment participations and Heizer stock to Heizer apparently in violation of Section 17(a)(1) with no relief afforded by Rule 17a-6.

[Note: Everything that was done was intended to help Omex and intended to be in the best interests of Heizer's investors. Heizer continues to believe that Omex has the potential to be a very successful company.]

Computer Consoles, Inc. ("CCI")

CCI was organized in 1968 to make equipment primarily for use in specialized data storage and retrieval. Its customars are principally operating telephone companies of the Bell System. It had a public offering of its common stock in 1968 and by 1971 was out of money. Heizer became involved in 1971 when it invested $2.3 million for voting preferred stock with warrants. It immediately acquired 68% voting control of the company. An officer of Heizer received an investment participation in connection with this financing, and another officer of Heizer received an investment participation in the CCI investment in 1973.

Since CCI's main business was to manufacture and lease equipment, it needed considerable financing. Loans which aggregated $8.0 million by the end of 1976 were obtained from Marine Midland Bank with a 50% participation by Citibank (an upstream affiliate of Heizer). In 1975 CCI experienced a decline both in revenues and net income. In 1976, it experienced a loss due in part to software problems encountered in connection with development of a new product line intended for use as a computerized directory assistance system for telephone companies. It went into default of certain of its bank loan covenants with Marine Midland Bank and Citibank and the banks threatened to foreclose on their loans. By November, 1976 it was unable to meet its payroll. Heizer stepped into the breach and started loaning money on a demand note basis to meet payroll and pay vendors. An aggregate of $1.2 million was loaned on this basis over a three month period.

It became apparent to Heizer that CCI's ability to finance its leasing of equipment to telephone companies was being severely restricted because of standard banking practices regarding loans to computer systems manufacturers. One of Heizer's directors had considerable experience in the leasing business, and he was assigned at the expense of CCI to work on the problem. As a result Heizer caused CCI to organize Computer Consoles Leasing Company ("CCLC") and arrangements were made with the Continental Bank of Chicago for a line of credit to CCLC initially of $15 million and later increased to $27 million. Arrangements were also made for working capital loans to CCI of up to $40 million based upon Heizer's commitment to purchase up to $1.8 million of preferred stock of CCI if necessary to help retire those loans. CCI invested $60,000 for all of the common stock of CCLC. Heizer invested $300,000 for preferred stock of CCLC and agreed to buy, if necessary, up to $2.0 million of notes of CCLC which would be subordinated to any bank loans from Continental. Although 100% of the voting securities of CCLC were owned by CCI, Heizer clearly controlled CCLC because the legal agreements provided that Heizer's commitments were good only so long as

CCI elected directors acceptable to Heizer. Initially the Board of Directors of CCLC consisted of three representatives from Heizer and two representatives from CCI. The executive officers of CCLC were officers of Heizer. As a part of the overall plan, CCLC borrowed $8.0 million from Continental Bank which was used to purchase leases and residual interests in the underlying equipment from CCI, thus permitting CCI to repay its note obligations to Marine Midland and Citibank.

Since 1976 CCI and CCLC have prospered. In 1978, CCI had sales and net income of $21.0 million and $1.3 million, respectively. Its backlog of orders for equipment at December 31, 1978 was $48.0 million, it provides employment for 460 employees and currently pays federal and state income taxes at an annual rate of $1.3 million. Heizer's agreement to purchase $1.8 million of CCI preferred stock to support working capital loans expired in March 1978 without any take-down being required. Continental Bank released Heizer in December 1978 from its commitments to support the line of credit to CCLC, and Heizer's officers have resigned as officers of CCLC and have been replaced by officers of CCI.

Section 17 Problems If Heizer Had Been Registered (partial list):

1. Since CCI became a controlled affiliate of Heizer when the first investment was made, subsequent investments by Heizer seem to be prohibited by Section 17(a)(1).

2. Financing of investment participations through officer notes appears to violate Section 17(a)(1).

3. The Heizer officers who in 1971 and 1973 received investment participations in CCI are no longer with Heizer. Their investment participations and Heizer stock were repurchased by Heizer apparently in violation of Section 17(a) with no relief afforded by Rule 17a-6.

4. CCI issued warrants rather than options to its directors (as part of a general program for all directors) which appears to violate Section 17(d) with no relief afforded by Rule 17d-1. The subsequent assignment of these warrants by Heizer representatives on the CCI Board of Directors to Heizer may violate Section 17(a)(1).

5. The employment of one of Heizer's officers who was working on the development of CCI was terminated in 1975. Within six months (notwithstanding Heizer's objections which were expressed to CCI's management and Board of Directors), he became an officer and director of CCI and was a participant in its director

warrant and employee stock purchase programs. As a result, those programs appear to violate Section 17(d) with no relief afforded by Rule 17d-1(d)(5).

6. The plan for establishing CCLC and refinancing CCI's debt to Marine Midland Bank and Citibank in 1976 may have been a joint enterprise prohibited by Section 17(d) with no relief afforded by Rule 17d-1(d)(5) for several reasons. Citibank is a first-tier upstream affiliate of Heizer.

7. The Section 17(d) problem created by a merger of Computer Consoles and Omex was mentioned in connection with the discussion of Omex.

[Note: The plan for establishing CCLC and refinancing CCI's debt to the banks was essential for the survival of this company.]

Other Companies

The case histories of Amdahl, Omex and Computer Consoles illustrate the types of Section 17 problems which Heizer would have faced in the development of these companies if it had been a registered investment company. Similar problems would have been encountered with other companies in which Heizer made significant investments. For example:

1. In connection with a long series of financings of Fotomat (in which both Heizer and Bessemer Securities Company acquired control), Heizer acquired third party warrants to purchase Fotomat stock from two of Fotomat's then directors and founding stockholders which would probably have violated Section 17(a)(1) and 17(a)(2) and may have been a joint enterprise prohibited by Section 17(d). Fotomat was saved by these financings and is today the largest retailer of photographic film and processing in the world (including Eastman Kodak).

2. Heizer "controls" both Cardiassist (medical services) and Commodore Corporation (mobile homes), who have a common affiliate in First National Bank of Boston and thus may be engaged in a joint enterprise prohibited under Section 17(d).

3. Heizer's first-tier upstream affiliate (Citibank) controlled Nortec (a manufacturers of semi-conductors) by virtue of defaulted bank loans before Heizer invested and acquired a control position. Subsequently, Heizer purchased

Citibank's notes at a substantial discount from face value. This purchase came about after the settlement of a lawsuit between Nortec and one of its customers who was also indebted to Citibank and was controlled by Bessemer Securities Company, which is a second-tier downstream affiliate of Heizer's through Fotomat Corporation. Monies were paid in the settlement to Citibank contrary to the terms of an intercreditor agreement between Citibank and Heizer. Heizer's claim against Citibank was settled when Heizer purchased Citibank's notes at a substantial discount.

4. Heizer controls Vilcor, which manages a large resort, condominium and hotel development in Hawaii owned by a joint venture in which Heizer's first-tier upstream affiliate, Northwestern Mutual, is a controlling party. This appears to be a joint enterprise prohibited by Section 17(d) and because of its significance to Vilcor and the fact that it is not a lessor-lessee relationship may not be exempt by virtue of Section 17(c) from the provisions of Section 17(a). It is Heizer's and Vilcor's objective to establish similar relationships with others including properties controlled by other first or second-tier upstream affiliates of Heizer (such as Prudential Insurance Company) and properties controlled by second-tier downstream affiliates of Heizer (such as Bessemer Securities Company, which is affiliated through Fotomat).

5. Heizer's affiliate (Northwestern Mutual) holds the first mortgage on the main plant facilities of Heizer's investee, Material Sciences Corporation. Material Sciences is a manufacturer of advanced materials and is currently engaged in the construction of a $28 million new facility to produce pre-coated rolled steel for the automobile industry which is less susceptible to rust and will help automobile manufacturers meet new manufacturing standards. Financing for the land and building portion of the facility ($11 million) recently fell through and Heizer approached Northwestern Mutual, which is active in real estate financing, to consider financing the land and building portion of the project. Northwestern Mutual has made an offer to do so and active negotiations are underway. Should these or other negotiations prove fruitless, Heizer may approach other upstream affiliates to provide the necessary financing.

Potential Affiliates Through Directorship

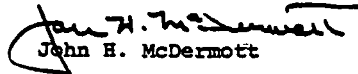
All of Heizer's affiliated investors serve on or have officers, directors or employees who serve on the boards of directors of other companies. To the extent that the definition of "affiliated person" in the 1940 Act may be construed

or changed to say that a company is an affiliate of its officers, directors or employees [discussed in the Rosenblat and Lybecker article in U. Pa. L. Rev. 587, 625 (1976)], Heizer's problems under Section 17 would be compounded greatly. For example: Amdahl Corporation has had dealings with IBM (not all of which might be considered as having been in the ordinary course of business) and IBM's board of directors includes W. H. Moore who is a director and former Chairman of the Board of Bankers Trust Company (an affiliate of Heizer). Another example is Donald S. McNaughton, Chairman of the Board and chief executive officer of the Prudential Insurance Company of America (an affiliate of Heizer) who is a member of the AT&T board). Heizer's controlled affiliate, Computer Consoles, Inc., does practically all of its business with Bell System. There are many similar situations.

Conclusions

For Heizer to engage successfully in its business, it must deal regularly with both upstream and downstream affiliates and with affiliates of those affiliates. Heizer needs active partners to help finance its investees. Affiliates are the class of people most likely to have confidence in Heizer's judgment, ability and perseverance and, therefore, the class of people most likely to supply necessary financing. In its first ten years of existence, Heizer invested in 32 companies. Nine of those 32 investments were failures and have been sold or otherwise disposed of through the bankruptcy court. It is significant to note that in the case of all nine failures, there was no significant participation in financing the investee company by any of Heizer's affiliates.

Very truly yours,



John H. McDermott

JHM:ds

cc: Mr. Martin E. Lybecker
Mr. Sidney L. Cimmet
Mr. Lawrence R. Bardfeld

HEIZER CORPORATION

SCHEDULE OF INVESTMENTS

AS OF DECEMBER 31, 1978 AND JUNE 30, 1978

	December 31, 1978		June 30, 1978	
	Cost	Fair Value	Cost	Fair Value
Amdahl Corporation -				
2,923,134 shares, common stock	$ 9,649,305	$ 39,729,600 (A)(I) 72,000,000 (A)(III) 2,740,499 (A)(IV)	$ 9,649,305	$ 8,688,054 (A)(I) 57,800,000 (A)(III) 15,837,951 (A)(IV)
Warrants to purchase common stock, 1,245,000 shares at $5, expiring 12/31/84, and 68,782 shares at $3.34, expiring 12/23/80	1,556,254	31,382,190 (A)(IV)	1,556,254	21,527,571 (A)(IV)
Option to purchase common stock, 12,000 shares at $.50, expiring 1/16/80	-	327,035 (A)(IV)	-	213,726 (A)(IV)
	$11,205,559	$146,187,324	$11,205,559	$104,067,302
Cardiassist Corporation				
2½% over prime, demand promissory notes, $590,606 in December 31, 1978 and $491,500 in June 30, 1978	$ 590,606	$ 1 (C)(IV)	$ 491,500	$ 491,500 (D)(IV)
68 shares, common stock	36,750	- (C)(IV)	36,750	36,750 (D)(IV)
	$ 627,356	$ 1	$ 528,250	$ 528,250
Commodities Corporation -				
1,026 shares, Class A common stock	$ 1,305,717	$ 2,044,000 (C)(IV)	$ 1,305,717	$ 3,938,200 (C)(IV)
The Commodore Corporation -				
Loan participation, 2½% over prime, due 10/1/80	$ 173,665	$ 174,000 (C)(IV)	$ 212,479	$ 197,000 (C)(IV)
700,000 shares, 8% Series B cumulative preferred stock	2,024,664	1,160,000 (C)(IV)	2,024,664	680,000 (C)(IV)
Warrants to purchase 4,000,000 shares common stock at $.50, expiring 12/31/86	-	- (C)(IV)	-	- (C)(IV)
	$ 2,198,329	$ 1,334,000	$ 2,237,143	$ 877,000
Computer Consoles, Inc. -				
1,210,000 shares, common stock	$ 2,600,000	$ 3,134,000 (C)(IV)	$ 2,300,000	$ 2,932,500 (C)(IV)
Warrants to purchase common stock, 5,000 shares at $6.125, expiring 9/13/79	-	- (C)(IV)	-	- (C)(IV)
Warrants to purchase common stock, 375,000 shares at $4.50, expiring 6/30/87	67,500	33,000 (C)(IV)	67,500	34,425 (C)(IV)
Computer Consoles Leasing Corporation (subsidiary of Computer Consoles, Inc.)-				
3,000 shares, 8% cumulative preferred stock at June 30, 1978; converted into 60,000 shares of Computer Consoles, Inc. common stock in December 1978	-	-	300,000	300,000 (D)(IV)
	$ 2,667,500	$ 3,167,000	$ 2,667,500	$ 3,266,925

	December 31, 1978		June 30, 1978	
	Cost	Fair Value	Cost	Fair Value
Computerized Products Corporation - 4,181,250 shares, common stock	$ 1,779,510	$ 434,000 (C)(IV)	$ 1,779,510	$ 394,000 (C)(IV)
Data 100 Corporation - 437,785 shares, common stock	POSITION SOLD		$ 1,835,089	$ 7,825,407 (A)(I)
Fatomat Corporation - 2,035,681 shares, common stock	$ 4,827,782	$ 3,885,200 (A)(I) 4,993,947 (A)(III) 8,115,158 (A)(IV)	$ 4,827,782	$ 2,230,415 (A)(I) 10,434,725 (A)(III) 10,434,715 (A)(IV)
Warrants to purchase 60,000 shares common stock at $20, subject to purchase price adjustment, expiring 10/22/79	110,427	4,860 (A)(IV)	110,427	7,920 (A)(IV)
	$ 4,938,209	$ 16,999,165	$ 4,938,209	$ 23,115,775
International Capital Equipment Ltd. - 6,000 shares, capital stock	$ 100,750	$ 1 (C)(IV)	$ 100,750	$ 1 (C)(IV)
Warrants to purchase 12,000 shares capital stock at $16.67, expiring 2/20/80	6,000	- (C)(IV)	6,000	- (C)(IV)
	$ 106,750	$ 1	$ 106,750	$ 1
IDC Services, Inc. (Note 13) -				
$3,762,000, 2½% over prime, demand notes	$ 3,813,920	$ 3,052,000 (C)(IV)	$ 3,823,666	$ 3,052,000 (C)(IV)
$1,319,508, 7-3/4% demand notes	1,338,026	1,771,000 (C)(IV)	1,341,450	$ 1,071,000 (C)(IV)
$1,700,000, 8% senior note, due 5/12/91	1,652,396	1,248,000 (C)(IV)	1,652,396	1,248,000 (C)(IV)
300,000 shares, 8.2% preferred stock	3,397,931	399,000 (C)(IV)	3,406,367	399,000 (C)(IV)
Warrants to purchase 1,304,000 shares common stock -- 276,223 shares currently at $4.32, expiring 11/5/79; 555,555 shares currently at $4.80, expiring 8/31/80; and 472,222 shares currently at $6.60, expiring 5/31/81	51,000	- (C)(IV)	51,000	- (C)(IV)
	$10,253,273	$ 6,470,000	$10,274,879	$ 5,770,000
Material Sciences Corporation - 32,000 shares, 8% preferred stock	$ 2,866,059	$ 2,697,000 (C)(IV)	$ 2,866,059	$ 2,514,000 (C)(IV)
101,000 shares, common stock	3,283,301	2,048,300 (C)(IV)	3,283,301	2,178,000 (C)(IV)
Warrants to purchase 320,000 shares common stock at $10, expiring 3/1/84	10,446	3,792,700 (C)(IV)	10,446	4,386,500 (C)(IV)
	$ 6,159,806	$ 8,538,000	$ 6,159,806	$ 9,078,500
KCR Corporation - 311,390 shares, common stock (8,110 shares held in escrow)	$ 2,793,876	$ 18,348,440 (A)(I) 245,328 (A)(IV)	$ 2,793,876	$ 15,998,020 (A)(I) 213,901 (A)(IV)
		$ 18,593,768		$ 16,211,921

	December 31, 1978		June 30, 1978	
	Cost	Fair Value	Cost	Fair Value
Paradyne Corporation - 344,285 shares, common stock	$ 1,965,584	$ 2,556,350 (A)(I) 973,007 (A)(III) $ 3,529,357	$ 1,965,584	$ 1,056,955 (C)(IV)
Red Carpet Inns, Inc. - 100,000 shares, common stock	$ 112,025	1 (C)(IV)	$ 112,025	$ 1 (C)(IV)
Spectra-Physics, Inc. - 134,761 shares, common stock	$ 634,099	$ 3,082,658 (A)(I)	$ 634,099	$ 2,290,937 (A)(I)
Stratford of Texas, Inc. - 297,000 shares, common stock	$ 2,078,924	$ 1 (C)(IV)	$ 2,078,924	$ 1 (C)(IV)
Warrants to purchase 297,000 shares at $10.00, expired 7/14/78	-	-	891,000	- (C)(IV)
	$ 2,078,924	$ 1	$ 2,969,924	$ 1
Inactive Companies: Information Management International, Inc.-	$ 1,885,692	$ 1 (C)(IV)	$ 1,885,692	$ 1 (C)(IV)
Investments -	$50,712,209	$210,379,277	$53,399,612	$178,421,176

Note (a): - Fair Value has been coded to indicate which of the following four valuation methods has been applied to the individual investments:

(A) - Public Market (B) - Private Market (C) - Appraisal (D) - Cost

Fair Value has also been coded to indicate which of the following Balance Sheet classifications has been applied to the individual statements:

(I) - Currently Publicly Marketable (II) - Currently Privately Marketable (III) - Currently Marketable Through Registration (IV) - Restricted Securities

HEIZER CAPITAL CORPORATION

SCHEDULE OF INVESTMENTS

AS OF DECEMBER 31, 1978 AND JUNE 30, 1978

	December 31, 1978			June 30, 1978		
	Cost	Fair Value		Cost	Fair Value	
Federal Express Corporation -						
9,900 shares, $9.50 cumulative preferred stock	$ 34,650	$ 990,000	(C)(II)	$ 34,650	$ 990,000	(C)(II)
34,738 shares, Class A common stock (adjusted for (September 1978, 2 for 1 stock split)	396,000	911,873	(A)(I)	396,000	694,760	(A)(I)
	$ 430,650	$ 1,901,873		$ 430,650	$ 1,684,760	
Nortec Electronics Corporation -						
$350,000, 10%, 180 day notes	$ 350,000	$ 228,000	(C)(IV)	$ 350,000	$ 221,000	(C)(IV)
$1,200,000 Note, plus interest and fees purchased from Citibank	250,000	250,000	(C)(IV)	250,000	250,000	(C)(IV)
	50,000	-	(C)(IV)	50,000	-	(C)(IV)
$952,102, 8% convertible subordinated note, due 2/14/82, convertible into 1,400,000 shares at $1.50 ($1,500,000 cost basis has been written off)	-	-	(C)(IV)	-	-	(C)(IV)
	$ 650,000	$ 478,000		$ 650,000	$ 471,000	
ONEX -						
2% over prime, certificates of indebtedness, $3,333,000 at 12/31/78 and $1,527,000 at 6/30/78	$ 3,333,000	$ 3,333,000	(C)(IV)	$ 1,527,000	$ 1,527,000	(D)(IV)
1,647,303 shares, 9% cumulative Class AA preferred stock	1,395,315	325,000	(C)(IV)	1,395,315	298,000	(C)(IV)
1,328,933 shares, Class AAA preferred stock	1,224,186	266,000	(C)(IV)	1,224,186	266,000	(C)(IV)
348,363 shares, common stock	1,599,181	3,484,000	(C)(IV)	1,599,181	3,483,630	(C)(IV)
	$ 7,551,682	$ 7,408,000		$ 5,745,682	$ 5,574,630	

To the Board of Directors
Heizer Corporation

We have reviewed Heizer Corporation's valuations of its investments as of June 30, 1978 and 1977. We have previously reviewed and concluded as to the reasonableness of Heizer Corporation's valuations of its investments as of June 30, 1974, 1975, and 1976. As in the past, our review this year included analysis of financial and operating data of the investee companies, visits and discussions with management of certain investee companies, and consideration of such other available information that we deemed relevant.

As a result of our review, it is our judgment that the valuation policies and methods followed by Heizer Corporation's management in arriving at the June 30, 1978 and 1977 valuations are consistent with those set forth in Heizer Corporation's Valuation Process manual. The valuation methods employed are also similar to those generally followed by our firm.

Although all such valuations are matters of qualitative judgment, it is our opinion that the June 30, 1978 and 1977 valuations of Heizer Corporation's investments as determined by management are reasonable.

Duff and Phelps, Inc.
DUFF AND PHELPS, INC.

Chicago, Illinois
August 28, 1978

EXHIBIT IV

GARDNER, CARTON & DOUGLAS

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*ADMITTED IN DISTRICT OF COLUMBIA ONLY

February 15, 1979

Mr. Sydney H. Mendelsohn
Director, Division of Investment
Management
Securities and Exchange
Commission
Washington, D.C. 20549

Re: Relief from the Investment Company Act of 1940 for Venture Capital Companies

Dear Mr. Mendelsohn:

This letter will supplement our discussions of January 26 concerning relief from the Investment Company Act of 1940 for venture capital companies in general and Heizer Corporation in particular. As you requested, Mr. John H. McDermott, outside corporate counsel for Heizer, is sending you a detailed summary of Heizer's recent transactions that would have been prohibited or restricted if Heizer were registered as an investment company. Mr. McDermott is also furnishing you a schedule of Heizer's current investments and the fair value thereof.

On the premise that those who make substantial investments in venture capital company securities do not need the protections

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of the 1940 Act (just as Rule 146 is based on the premise that such investors do not need the protections of the 1933 Act), you suggested the possibility of a rule under Section 3(c)(1) that would exempt from the computation of the number of beneficial owners thereunder any person who purchases securities of the venture capital company for $150,000 or more.* We have explored this idea of a $150,000 threshold (or even $50,000 or $25,000) with investment bankers, representatives of the National Venture Capital Association and the National Association of Small Business Investment Companies, and others. Their conclusion is unanimous--while your suggestion would provide an important boost for venture capital companies in their start-up stages, it would do little to relieve the long-term liquidity problems of their investors that we focused on in our submission of December 20, 1978.

We are advised that, as a practical matter, a meaningful trading market for equity securities carrying such a high price will not develop. Furthermore, we have encountered numerous practical and theoretical problems in attempting to formulate a rule employing the threshold concept that could be applicable

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*If we understand your proposal correctly, the suggested rules under Section 3(c)(1) would be available to any company that would otherwise be an investment company -- not only those that meet a definition of venture capital company. Our interest, as you know, is solely that of venture capital companies.

to venture capital companies over many years. In essence, it does not seem feasible for an issuer effectively to tie up its securities in such a manner over a long period. For example, after a few years it would be difficult, if not impossible, for the issuer to ensure that its securities are traded in the aftermarket at a price in excess of the threshold. What can the issuer do about disposals of its securities by gift, will or pledge? How could a rule be drafted so as to handle acquisitions of securities through the exercise of warrants or conversion privileges, which are essential to a venture capital company in its startup phases? What about stock splits if the trading price of the securities increases dramatically? The indicated controls are feasible as long as the securities retain the status of restricted securities under the Securities Act, during which period all transfers are prohibited unless prescribed conditions are met to the satisfaction of the issuer or its counsel. As a practical matter, however, they seem to be inconsistent with a status of "free" securities and any degree of active trading.

Even if these rule-making problems could be solved, there would remain the fact that a trading market limited to such large units would not provide adequate liquidity for equity securities. Unlike fixed income securities, common stocks or their equivalents require an active round-lot market and quotation and reporting mechanisms before professionals will accept the market as liquid.

When we combine the recitals in Mr. McDermott's memorandum with the importance of eventual liquidity and the necessary mar-

ket ingredients to provide liquidity, we arrive at the position that we must seek a broader Investment Company Act exemption for venture capital companies, conditioning the exemption upon characteristics that avoid the major aspects of traditional investment companies that led the Congress to conclude that investors therein needed the special protections of the Act. Obviously this latter prospect involves reasonable judgment and balancing. The possible harm to the interests of investors at which the Act is directed is present to a degree in any corporation; but Congress has decided that the likelihood of harm requires these special protections only when a company meets one of the definitions of an investment company and even then -- recognizing the manifold complexities of trying to separate investment companies from all other companies, at least at the "lower" end of the scale -- only when the Commission agrees that the protections cannot be dispensed with. In exercising this judgment the Commission must weigh the probability of harm from the removal of the protections against the economic and social good that will be fostered by the removal.

Pursuing this line of thought, we propose a rule-making approach that utilizes your suggestion for new and unseasoned venture capital companies, while coordinating the special treatment of a rule under Section 3(c)(1) with the Securities Act exemption under Rule 146. This recognizes the proposition that small investors might not be invited into venture capital companies generally, except for those (up to 35) with respect to whom the standards of Rule 146 are satisfied.

Our proposal would, however, go a significant step beyond this and assert the position that, when a venture capital company has become "seasoned", the protections of the Act are not necessary, even for small investors. Seasoning would be based upon a demonstration that the company was indeed performing the economic purpose that justifies special treatment for venture capital companies, while at the same time maintaining a minimum persistency of continued investment to reduce the fundamental problem to which the Act is addressed -- <u>viz.</u>, assets consisting predominantly of marketable securities and cash that present peculiar temptations for misuse. Of course, a company can become static, having ceased to perform any continuing economic function in providing venture capital. However, no special standard seems needed against this contingency, inasmuch as the Commission can always challenge a company that claims an exemption on the ground that it is primarily engaged in the venture capital business but in fact no longer is.

Accordingly, we think it is possible to write rules protecting small investors while facilitating the attraction of capital by venture capital companies in their early years. As a starting point, we are enclosing as Exhibit A a proposed rule that would exclude from the computation of the number of beneficial owners under Section 3(c)(1) any person who purchases securities issued by a defined "venture capital company" for $150,000 or more in an offering that complies with the requirements of Rule 146. Enclosed Exhibit B sets forth our suggested definition

of "venture capital company," which is intended to be of narrow applicability.

Exhibit C is a proposed rule that (a) would exempt seasoned venture capital companies from the Act, (b) would provide investors with an opportunity for reasonable liquidity after the first few years, and (c) would insulate those investors from the abuses that can arise from the control of a large pool of liquid capital. As you will note, this draft rule supplements our proposed definition of "venture capital company" with additional, deliberately narrow, criteria--that the issuer have been continuously engaged for at least five years as a venture capital company, that its net assets be substantial (at least $10,000,000), and that its investment portfolio be stable. Five years, while necessarily arbitrary, is derived both from the experience of Heizer and others and the proposed revision to Rule 144 under the 1933 Act.

We look forward to discussing these and other ideas with you and the staff at our meeting on Friday, March 2, 1979, at 10:00 a.m. We hope that Mr. Heizer also will be present at that meeting.

Very truly yours,

Ray Garrett, Jr.

RGjr/PHD/lb

cc: Mr. Martin E. Lybecker
Mr. Sidney L. Cimmet
Mr. Lawrence R. Bardfeld

bcc: Mr. E. F. Heizer, Jr.
Mr. John H. McDermott

Rule 3c-4. Definition of beneficial ownership in non-public offerings.

For the purpose of computing the number of persons who beneficially own securities under section 3(c)(1) of the Act, a person shall not be deemed a beneficial owner of securities issued by a corporation engaged or proposing to engage in the business of a "venture capital company" as defined in Rule 2a-5 hereunder and such securities shall not be deemed part of a "public offering" under section 3(c)(1) of the Act if (i) all of the securities of such issuer are issued in compliance with the requirements of Rule 146 under the Securities Act of 1933 and (ii) such person purchases such securities from the issuer thereof for not less than $150,000 or from a person or persons other than the issuer for not less than $150,000.

Securities shall be conclusively presumed to have been purchased or otherwise acquired by a single person for purposes of this rule if the issuer and any person acting on its behalf shall exercise reasonable care to assure that the purchaser of the securities is a single person. Such reasonable care shall include, but not be limited to, the following:

(1) in case of sales by the issuer, making reasonable inquiry to determine that the purchaser is acquiring the securities for his own account and not on behalf of other persons;

(2) placing a legend on the certificate or other documents evidencing the securities setting forth or referring to the restrictions on transferability and sale of the securities, including the indivisibility thereof;

(3) issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

(4) obtaining from the purchaser a signed written agreement that the securities will not be sold or otherwise transferred except in accordance with clause (ii) of this rule.

There shall be counted as one purchaser any corporation, partnership, association, joint stock company, trust or incorporated organization.

Clients of an investment adviser, customer of a broker or dealer, trusts administered by a bank trust department or persons with similar relationships shall be considered to be the purchasers for purposes of this rule regardless of the amount of discretion given to the investment advisor, broker or dealer, bank trust department or other person to act on behalf of the client, customer or trust.

Proposed Rule 2a-5

"Venture capital company" means any issuer that (a) is engaged or proposes to engage principally in the business of furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities; and (b) holds securities, of which at least 80% (exclusive of government securities, short-term paper, other cash items, and securities issued by such issuer) consists of (i) securities acquired directly from the issuer thereof in a transaction or transactions not registered under the Securities Act of 1933 or pursuant to the exercise of options, warrants or rights acquired in such transactions, (ii) securities received in exchange therefor in a reorganization described in Sections 368 or 371 of the Internal Revenue Code of 1954, as amended, or in any exchange offer, and (iii) securities distributed on or with respect to any such securities.

Rule 6c-4. Exemption for established venture capital companies.

An issuer shall be exempt from all provisions of the Act applicable to investment companies as such if each of the following conditions is met:

(a) The issuer is engaged and has been continuously engaged for at least five prior years in the business of a venture capital company as defined in Rule 2a-5 hereunder;

(b) The net asset value of the securities held by such issuer, as of the end of its most recent fiscal year, is at least $10,000,000; and

(c) At least 50% in cost of fair value of the securities held by such issuer consists of securities the issuer has held continuously for at least the five prior years. For the purposes of this paragraph, securities of the kind described in clauses (ii) or (iii) of Rule 2a-5 hereunder shall be deemed to have been acquired at the same time as the securities described in clause (i) of Rule 2a-5 hereunder.

EXHIBIT V

GARDNER, CARTON & DOUGLAS

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*ADMITTED IN DISTRICT OF COLUMBIA ONLY

April 13, 1979

Sydney H. Mendelsohn, Esq.
Director, Division of Investment
Management
Securities and Exchange Commission
Washington, D.C. 20549

Re: Relief from the Investment
Company Act of 1940
<u>for Venture Capital Companies</u>

Dear Mr. Mendelsohn:

This letter will supplement our discussions of March 2 with you and your staff concerning relief from the Investment Company Act of 1940 for venture capital companies in general and Heizer Corporation in particular. Our discussions at that meeting focused on two topics: (1) a rule under Section 3(c)(1) of the Act that would exempt all defined venture capital companies from registration under the Act if their own securities are purchased in private offerings for $150,000 or more per unit, and (2) a rule or order under Section 6(c) that would exempt seasoned venture capital companies from some or all of the provisions of the Act. This letter will concentrate upon proposed exemptive rules of general applicability to

companies engaged in furnishing capital to young or developing businesses. Mr. John H. McDermott, outside corporate counsel for Heizer, is sending you a summary of a proposed application by Heizer for an exemptive order pursuant to Section 6(c) of the Act. Depending upon your preference, we are, of course, prepared to pursue either alternative.

You have expressed your support for an exemption for venture capital companies from registration under the Act if their securities are purchased in initial offerings for $150,000 or more per unit and traded only in comparable units thereafter, and you have advised us that the Division is prepared to urge that a proposed rule to that effect be issued for comment as soon as an acceptable definition of "venture capital company" can be formulated. As we understand your position, this definition ought to concentrate upon the kind of companies in which the venture capital company invests rather than on the mix of the securities in its portfolio (i.e., privately placed, held for at least five years, etc.). Your objective is that any definition be narrowly drawn to ensure that it includes only those relatively few entities that are engaged in the socially desirable activity of providing capital to young or developing enterprises; you wish to be certain that other entities that are not in fact engaged in furnishing devolpment capital would not come within the terms of the exemption.

Accordingly, you suggested that one ingredient in the definition might be a size limitation on the investee companies, expressed in terms of ceilings on each investee's

tangible net worth, net income, and possibly the market value of its outstanding securities. We have explored this idea and have concluded that the size of an enterprise, as measured by its current balance sheet or income statement, is simply not a reliable indicator of its maturity, its need for development capital or its access to capital at reasonable cost from other sources. Moreover, we have not been able to formulate a definition of venture capital company using the size concept that would effectively exclude other investment entities that are not significantly engaged in the financing of emerging companies.

Regardless of the definition of venture capital company that you formulate for purposes of the $150,000 rule, you have further stated that you would not expect it to provide a basis for total exemption or exclusion from the Act if there were no limitation on the minimum investment even in the secondary market, regardless of any period (5 years, for example) of "seasoning". We nevertheless remain convinced that substantially total exemption is the necessary goal, so we have continued to search for the proper criteria to identity companies entitled to such exemption based upon (i) a substantial contribution to "true" venture capital financing and (ii) the possession of characteristics that remove or sufficiently reduce the possibility of those abuses that the Act is directed toward.

In this pursuit we have recogized that these criteria cannot be met by all companies that currently describe themselves as "venture capital companies" nor by all companies that fit the definition that you may propose for purposes of the $150,000 rule. To avoid confusion, therefore, we propose a new category of companies that will qualify for total exemption. We shall call these companies "business development companies". Under this approach, depending upon the definitions finally adopted, not all venture capital companies will be business development companies but all business development companies will be venture capital companies. The latter proposition is important, because under our proposals a business development company would begin life either under a Section 3(c)(1) exemption or that to be provided by the $150,000 rule. Only when "seasoned" and possessed of prescribed protective features would it qualify for total exemption free from the limitations of that section or that rule.

Proposed Rule 2a-5. Definition of Business Development Company

The purpose of this definition is to identify companies that have made and are making capital directly available to young or developing enterprises whose capital needs are not "bankable" through conventional sources as well as companies who take an active and constructive role in the development of the "investee" companies. Coming within this definition will provide a basis for total exemption but only when there is further compliance with the conditions of the proposed exemptive rule.

The key feature of our suggested definition, we think, is paragraph (b)(4). This provision requires in substance that, as to at least 80% of its net assets, the defined business development company be the beneficial owner of more than 10% of the voting securities of the investee as of the time of the initial investment (on a pro forma basis, after the exercise of all options, warrants, rights and conversion privileges acquired by the business development company).

This approach, in our view, is desirable for several reasons. First, by requiring the entity making the investment to acquire more than 10% of the investee's voting securities at the time of the initial investment, it virtually assures the active involvement by that entity in the operations of the investee, which (as we stressed in our submission to Congress of December 20, 1978) is a characteristic peculiar to venture capital companies which are engaged in business development. Second, the floor of 10% will preclude, as a practical matter, the acquisition of securities of larger issuers that may not be in need of development capital. Third, the provision is objective, thereby permitting both the staff and the securities bar readily to determine compliance.

Finally, it is, we think, rigidly exclusive--few if any entities other than those that are in fact furnishing capital to young or developing businesses will be able to use it. For example, as you well know, the investment policy of virtually every mutual fund or closed-end investment company prohibits it from acquiring more than 10% of the voting securities of any one entity, so that it may qualify for the pass-through

tax treatment granted by Subchapter M of the Internal Revenue Code.* Similarly, because SBICs, in addition to relying on Subchapter M, are prohibited by the SBA from exercising "control" over their investees, they too would be reluctant in many cases to acquire more than 10% of the voting securities of any one issuer.

Our proposal retains the subjective "definition" of business development company in substantially the form adopted by Congress as Section 12(e) of the Act. In order to narrow our proposed definition still further and assure that needed capital is furnished directly to the emerging enterprise, we have also retained our earlier suggestion that at least 80% of the net assets of the defined business development company consist of securities acquired in private placements (see subparagraphs (1), (2) and (3) of paragraph (b) of Exhibit A). Here, too, the definition is not only objective but also applicable to only a very small class of investment entities.**

---

* The only relevant exception to this 10% ceiling (which applies to 50% of the company's assets) allowed by Subchapter M is accorded a company "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products nor previously generally available." (I.R.C. §851(e)). This provision is similar to clause (a) of our proposed definition of business development company, which, as noted above, is itself taken from Section 12(e) of the 1940 Act. It should be noted that this exception in the Code (which was added in 1951) is operative only upon a certification by the Commission under regulations issued by it, which, to our knowledge, have never been promulgated.

** The only other entities that might conceivably meet this private placement criterion are SBICs and the private placement bond funds that were popular a few years ago. None of these bond funds, though, would meet the standard set forth in subparagraph (4) of our definition.

Proposed Rule 3c-4. Definition of Beneficial Ownership of Securities of Business Development Companies Acquired in Non-public Offerings

Proposed Rule 3c-4 (Exhibit B hereto), as we have discussed in previous meetings, would provide significant relief to defined business development companies in their start-up stages. Because you have already indicated your general agreement with this concept and because we understand the staff is currently formulating a new rule along these lines, we shall not dwell upon our proposal here except to note that we have deleted the reference to Rule 146 that appeared in our earlier proposal to the staff and substituted a reference to Section 4(2) of the 1933 Act. This has been done in order to provide securities lawyers with a broader basis on which to opine that a transaction did not involve any public offering. As a practical matter, Rule 146 is infrequently used as the legal basis for a non-public offering. Moreover, it would be difficult, if not impossible, for counsel for a third party to conclude, sometimes long after the fact, that an offering complied with each of the requirements of Rule 146. If a business development company is also a venture capital company as defined for purposes of the $150,000 rule, there will, of course, be no need for a separate rule under Section 3(c) directed toward business development companies.

Proposed Rule 6c-4. Exemption for Established Business Development Companies

It is likely that all of us are in general agreement with the proposition that there is a serious shortage of business development capital for emerging enterprises in this country. There is likewise little doubt that business development companies can help to alleviate this shortage significantly. As we stressed in our submission of December 20, 1979, however, unless a means can be found to provide the initial investors in a business development company with real liquidity on their investments while at the same time relieving the company of the constraints of the Act that make its operation as a registered investment company impossible, every business development company must ultimately terminate its operations as such. That result is plainly contrary to the public interest. Our problem, then, has been to combine what is in the public interest--the continuation of established business development companies and the encouragement of new ones--with the protection of investors. We think we have done so in our proposed Rule 6c-4 (Exhibit C hereto).

This Rule, which is patterned closely after the Commission's proposed Rules 10f-3 and 17e-2, recognizes the enhanced role of disinterested directors in safeguarding the interests of shareholders. We think it succeeds in preserving the investor protections mandated by the Act while achieving the social and economic good that would flow from allowing business development companies to function on a long-term basis.

The Rule would be applicable only to that narrow group of issuers meeting the definition of "business development company" and then only to those that have operated continuously as such for at least five years. It goes beyond Section 10(a) of the Act by requiring that no more than 40% (not 60%) of the business development company's board of directors be interested persons as defined in the Act.

The key element of the Rule would obligate the disinterested directors to adopt and continuously review procedures designed to ensure the protection of investors. Subparagraph (c)(2) of the Rule would require that these procedures flatly prohibit <u>any</u> transaction between the business development company and any of its directors, officers, employees, partners or co-partners if the transaction would violate Section 10(f) or Section 17(a) or (d) of the Act (except as otherwise permitted by the Commission's rules), assuming the business development company were a registered investment company. Similarly, subparagraph (c)(3) would bar a transaction between any of these persons and any other affiliate of the business development company if the transaction would be violative of Section 10(f), 17(a), or 17(d) and the rules thereunder. Subparagraph (c)(4) of the proposed Rule would condition the exemption upon the adoption of a procedure designed to prohibit any transaction between the business development company and any person (or its affiliate) controlling it.

Most important, subparagraph (c)(5) of the Rule would prevent <u>any</u> other transaction that would be prohibited by <u>any</u> provision of the Act unless a majority of the business

development company's disinterested directors, or a committee thereof, renders its prior approval of the transaction. This portion of the proposed Rule, then, would extend not only to transactions prohibited by Section 10 or Section 17, but to the entire Act, including Sections 18, 22, and 23. Consistent with the increased reliance that the Commission is placing upon an issuer's disinterested directors to ensure investor protection, these directors would be responsible for determining in advance that every transaction entered into by the business development company that would otherwise require an exemptive order under the Act is fair and reasonable to the shareholders, is in their best interests, and does not involve overreaching of the business development company or its shareholders. We are confident that such a format would achieve the full measure of investor protection required the Act.*

As an added measure of protection for the shareholders, subparagraph (6) of our proposed Rule 6c-4 would require that the business development company's independent public accountants be selected and approved by both its disinterested directors and its shareholders. Further, an independent appraiser, who would opine annually upon the portfolio valuation, would be selected and approved by the disinterested directors and the shareholders.

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* We note that a reliance upon the approval of the outside directors in this context is not an idea original with us but was advanced by others more than three years ago. Rosenblat and Lybecker, "Some Thoughts on the Federal Securities laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project," 124 U.Pa.L.Rev.587 (1976). Moreover, as already noted, it is consistent with the framework urged by the Commission in proposed Rules 10f-3 and 17e-2.

The effect of these procedures, in our view, would be to provide investors in business development companies with real protections against self-dealing and unsound capital structures while at the same time according these entities at least a neutral environment in which to function in the public interest. This framework, we should reiterate, is not new but is based upon standards that have previously been endorsed by the Commission or members of its staff.

We think the procedures will work. However, should it be desirable to augment them with supervisory powers of the Commission, it would be possible to condition the exemption upon an initial filing, which would "perfect" the exemption, followed by periodic reports confirming the continued existence of the facts upon which the exemption is based. Likewise, the initial filing by which the exemption is perfected could include the consent of the issuer to rights of inspection comparable to those the Commission has with respect to registered investment companies.

We look forward to discussing the foregoing proposals with you at our meeting in Washington on Friday, April 20, 1979, at 10:00 a.m.

Very truly yours,

Ray Garrett, Jr.

RGjr/PHD/jah

cc: Chairman Harold M. Williams
Martin E. Lybecker, Esq.
Sidney L. Cimmet, Esq.
Lawrence R. Bardfeld, Esq.

bcc: E. F. Heizer, Jr., Esq.
John H. McDermott, Esq.
John M. Lison, Esq.

EXHIBIT A

Rule 2a-5. Definition of "business development company."

"Business development company" means any company that meets each of the following conditions:

(a) It is engaged or proposes to engage principally in the business of furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities; and

(b) At least 80% of its net assets (exclusive of securities issued by such issuer, Government securities, short-term paper and other cash items) consists of securities which were:

(1) Acquired directly from the issuer thereof (the "investee") in a transaction or transactions not involving securities registered under the Securities Act of 1933 or pursuant to the exercise of options, warrants or rights acquired in such transactions; or

(2) Received in exchange for securities acquired pursuant to subparagraph (1) above in a reorganization described in sections 368 or 371 of the Internal Revenue Code of 1954, as amended, or in any exchange offer; or

(3) Distributed on or with respect to any such securities; and

(4) Issued by an investee or any successor thereto more than 10% of whose voting securities became beneficially owned by the company as a result of the initial acquisition by the company of securities of the investee.

For purposes of subparagraph (4) above, a beneficial owner of a security includes any company which, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares (i) voting power which includes the power to vote or to direct the voting of, such security, or (ii) investment power which includes the power to dispose, or to direct the disposition of, such security. A company shall likewise be deemed to be the beneficial owner of a security for purposes of subparagraph (4) above if that company has the right to acquire beneficial ownership of that security, as defined above, within sixty days, including but not limited to any right to acquire (i) through the exercise of any option, warrant or right or (ii) through the conversion of a security. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such company but shall not be deemed outstanding for the purpose of computing the percentage of the investee's securities owned by any other person.

EXHIBIT B

Rule 3c-4. Definition of beneficial ownership of securities of business development companies acquired in non-public offerings.

For the purpose of computing the number of persons who beneficially own securities under section 3(c)(1) of the Act, a person shall not be deemed a beneficial owner of securities issued by a corporation engaged or proposing to engage in the business of a "business development company" as defined in Rule 2a-5 if the person purchased the securities in a transaction or transactions not involving any public offering within the meaning of section 4(2) of the Securities Act of 1933 and for an amount of not less than $150,000 for each transaction.

EXHIBIT C

Rule 6c-4. Exemption for established business development companies.

An company shall be exempt from section 7 of the Act if each of the following conditions is met:

(a) The company is engaged and has been engaged continuously for at least the five prior calendar years in the business of a "business development company" as defined in Rule 2a-5 hereunder;

(b) At least 60% of the members of the company's board of directors are not "interested persons" of the company as defined in section 2(a)(9) of the Act ("disinterested directors");

(c) The company's board of directors, including a majority of the disinterested directors, have adopted procedures which are reasonably designed to provide that:

(1) the conditions of this rule in paragraphs (a) and (b) have been complied with;

(2) the company does not effect any transaction with any of its directors, officers, employees, partners, or copartners that would be prohibited by section 10(f), 17(a) or 17(d) of the Act and the rules thereunder if the company were registered as an investment company under the Act;

(3) none of the directors, officers, employees, partners, or copartners of the company effects a transaction with any other party that would be prohibited by section 10(f), 17(a) or 17(d) of the Act and the rules thereunder if the company were registered as an investment company under the Act;

(4) the company does not effect any transaction with a person controlling the company within the meaning of the Act, or with any affiliated person of such person, that would be prohibited by section 10(f), 17(a) or 17(d) of the Act and the rules thereunder if the company were registered as an investment company under the Act;

(5) the company does not effect any other transaction that would be prohibited by any provision of the Act and the rules thereunder if the company were registered as an investment company under the Act unless a majority of the issuer's disinterested directors, or a committee thereof, renders its prior approval of such proposed transaction and concludes that

(i) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair to the shareholders

of the company and do not involve overreaching of the company or its shareholders by another party, and

(ii) the proposed transaction is in the interests of the company's shareholders and is consistent with the policy of such company as recited in its articles of incorporation and any other documents made available to its shareholders generally; and

(6) the company prepares and furnishes annually to each of its shareholders of record no later than 120 days after the end of its fiscal year an annual report containing the information required of an issuer by section 13(a) of the Securities Exchange Act of 1934 and the rules thereunder, which information includes:

(i) financial statements that are signed or certified by an independent public accountant selected and approved by a majority of the disinterested directors and the shareholders of the company in the manner set forth under section 32(a) of the Investment Company Act of 1940 if the company were registered as an investment company under that Act, and

(ii) a schedule of its portfolio securities valued in a manner approved by a majority of the disinterested directors and accompanied by an opinion of an independent appraiser selected

and approved at least annually by a majority of the disinterested directors and the shareholders of the company to the effect that such resulting valuations are reasonable;

(d) The company's board of directors, including a majority of the disinterested directors,

(1) review no less frequently than annually the procedures referred to in paragraph (c) above for their continuing appropriateness, and

(2) review no less frequently than quarterly whether all transactions of the issuer during the preceding quarter were effected in compliance with the procedures; and

(e) The company maintains and preserves permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in paragraph (c) of this rule and maintains a written record of each transaction to which the procedures required by paragraph (c) of this rule were applicable and preserves the record for a period of not less than six years from the end of the fiscal year in which any such transaction occurred the first two years in an easily accessible place; the written record shall set forth the parties to the transaction, the terms of the transaction, and the information or materials upon which any determination described in paragraph (c) of this rule was made.

EXHIBIT VI

McDERMOTT, WILL & EMERY
III WEST MONROE STREET
CHICAGO, ILLINOIS 60603
312-372-2000

CABLE ADDRESS
"MILAM"
TELEX NUMBER
25-3565
TELECOPIER
312-372-2022

700 BRICKELL AVENUE
MIAMI, FLORIDA 33131
305-358-6030
1101 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20036
202-223-9450

April 13, 1979

Sydney H. Mendelsohn, Esq.
Director, Division of Investment
Management
Securities and Exchange Commission
Washington, D. C. 20549

Re: Proposed Application by Heizer Corporation for an Order of Exemption Pursuant to Section 6(c) of the Investment Company Act of 1940

Dear Mr. Mendelsohn:

At our meeting on March 2, you indicated a willingness to further discuss a proposed application by Heizer Corporation for an order of exemption pursuant to Section 6(c) of the Investment Company Act of 1940. A draft application in summary form is enclosed for this purpose. The conditions upon which the proposed order would be based are intended to conform with the proposed rules of general applicability which Heizer's special counsel, Mr. Ray Garrett, is sending to you on this date.

I look forward to discussing this alternative with you at our meeting in Washington on Friday, April 20, 1979, at 10:00 a.m.

Very truly yours,

John H. McDermott

JHM:ds
Enc.

cc: Chairman Harold M. Williams
Martin E. Lybecker, Esq.
Sidney L. Cimmet, Esq.
Lawrence R. Bardfeld, Esq.

55-753 O - 80 - 30

DRAFT: 4/13/79

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

APPLICATION FOR

ORDER OF EXEMPTION FROM THE INVESTMENT COMPANY ACT OF 1940

PURSUANT TO SECTION 6(c) OF

THE INVESTMENT COMPANY ACT OF 1940

HEIZER CORPORATION
20 North Wacker Drive
Chicago, Illinois 60603

Comments and Questions Directed to:

Corporate Counsel:

John H. McDermott
McDermott, Will & Emery
111 West Monroe Street
Chicago, Illinois 60603
(312) 372-2000

E. F. Heizer, Jr.,
President and Chairman of the Board, or
John M. Lison, Vice President - Legal
Heizer Corporation
20 North Wacker Drive
Chicago, Illinois 60606
(312) 641-2200

Special Counsel:

Ray Garrett, Jr.,
or
Paul H. Dykstra
Gardner, Carton & Douglas
One First National Plaza
Suite 4600
Chicago, Illinois 60603
(312) 726-2452

1120 Connecticut Ave., N.W.
Suite 325
Washington, D. C. 20036
(202) 833-5710

Administrative Proceeding
File No.

UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of HEIZER CORPORATION 20 North Wacker Drive Chicago, Illinois 60606 Under the Investment Company Act of 1940	APPLICATION FOR AN ORDER OF EXEMPTION FROM THE INVESTMENT COMPANY ACT OF 1940 PURSUANT TO SECTION 6(c) OF THE INVESTMENT COMPANY ACT OF 1940.

Heizer Corporation ("Heizer"), hereby applies for an order of the Securities and Exchange Commission (the "Commission"), pursuant to Section 6(c) of the Investment Company Act of 1940, as amended (the "Act"), exempting Heizer from Section 7 of the Act on the conditions set forth herein.

It is anticipated that the next two parts of the application will consist of sections describing the background of Heizer and reasons why the application should be granted. Since practically all of this information has been previously furnished informally as part of the submission of Gardner, Carton & Douglas dated December 20, 1978, the letter of McDermott, Will & Emery to Sydney H. Mendelsohn dated February 15, 1979, or has been discussed in meetings with the staff, it is not set forth in detail in this draft application.

Background

[This section will describe the history of Heizer since it was organized in 1969, its capital structure, a list of its investors, the types of investments made, the manner in which investments are made, how investments are valued, financial statements which include the current value of its investments, a description of Heizer's directors, officers, employees and partners, their interests in Heizer, how they are compensated,

any current transactions or interests which would cause a director to be deemed an "interested director" or cause Heizer not to be in compliance with the proposed conditions upon which the application is based, etc.]

Reasons for Exemption

[This section will describe the inability of Heizer to engage in the business of supplying early stage development capital if it is not exempt from the Act, the requirement of Heizer's investors for liquidity with respect to their investments in Heizer, and the inability of Heizer to satisfy investor demands for liquidity other than through its own liquidation if Heizer is not exempt from the Act. This section will also demonstrate that the exemption being requested is necessary and appropriate in the public interest. It will cite the need for business development capital in the U.S. economy and current governmental policies with respect to capital formation and will make reference to the White House capital formation task force, being headed by E. F. Heizer, Jr. Finally, the section will demonstrate that the exemption being requested is consistent with the protection of investors because of the conditions upon which it is based, the history of Heizer and the procedures adopted by it to prevent abuse, and will show that the exemption is consistent with the purposes fairly intended by the policy and provisions of the Act.]

Proposed Conditions of Exemption

Heizer requests that the order of exemption applied for hereby be made subject to Heizer's compliance with the following conditions when the order is entered and that it be subject to revocation by order of the Commission if thereafter Heizer ceases to be in substantial compliance with such conditions:

(a) Heizer shall be engaged in the business of and is a business development company as defined in Appendix A hereto.

(b) At least 60% of the members of Heizer's Board of Directors are not "interested persons" of Heizer as defined in Section 2(a)(19) of the Act ("disinterested directors"); provided that, if at any time subsequent to the order, Heizer shall fail to comply with this condition because of the death or resignation of a director or for any other reason beyond its control, Heizer shall be deemed to be in continuing compliance herewith for a period of up to 180 days so long as Heizer uses its best efforts during such period to cause to be elected a Board of Directors at least 60% of whose members are disinterested directors.

(c) Heizer's Board of Directors, including a majority of the disinterested directors, have adopted by-laws containing provisions which establish policies relating to the business of Heizer and the conduct of its affairs substantially as follows, which provisions shall be in force and shall not have been modified in any material respect:

(1) It is the policy of Heizer (i) that it be engaged in the business of and be a business development company as defined in Appendix A hereto, and (ii) that its Board of Directors consist at all times of persons at least 60% of whom are disinterested directors;

(2) Heizer shall not effect any transaction with any of its directors, officers or employees that would be prohibited by Sections 10(f), 17(a) or 17(d) of the Act and the rules thereunder if Heizer were registered as an investment company under the Act;

(3) Heizer shall not knowingly permit any of the directors, officers or employees of Heizer to effect any transaction with any other party that

would be prohibited by Sections 10(f), 17(a) or 17(d) of the Act and the rules thereunder if Heizer were registered as an investment company under the Act;

(4) Heizer shall not effect any transaction with a person controlling Heizer within the meaning of the Act, or with any affiliated person of such person, that would be prohibited by Sections 10(f), 17(a) or 17(d) of the Act and the rules thereunder if Heizer were registered as an investment company under the Act;

(5) Heizer shall not effect any other transaction that would be prohibited by any provision of the Act and the rules thereunder if Heizer were registered as an investment company under the Act unless a majority of Heizer's disinterested directors, or a committee thereof, shall have rendered their prior approval of such proposed transaction and shall have concluded that (i) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair to the shareholders of Heizer and do not involve overreaching of Heizer or its shareholders by another party, and (ii) the proposed transaction is in the interests of Heizer's shareholders and is consistent with the policies of Heizer as recited in its articles of incorporation, by-laws, and any other documents made available to its shareholders generally;

(6) Heizer shall prepare and furnish annually to each of its shareholders of record no later than 120 days after the end of its fiscal year an annual

report containing the information which would be required of Heizer by Section 13(a) of the Securities Exchange Act of 1934 and the rules thereunder, if Heizer were subject thereto, which information includes:

(i) financial statements as required by said Section 13(a) of the Securities Exchange Act of 1934 and the rules thereunder which are signed or certified by an independent public accountant selected and approved by a majority of the disinterested directors and the shareholders of Heizer in the manner set forth under Section 32(a) of the Investment Company Act of 1940 if Heizer were registered as an investment company under that Act, and

(ii) a schedule of its portfolio securities valued in a manner approved by at least a majority of Heizer's disinterested directors and accompanied by an opinion of an independent appraiser selected and approved at least annually by a majority of the disinterested directors and the shareholders of Heizer.

(d) Heizer's Board of Directors, including at least a majority of its disinterested directors, shall adopt such further procedures as it deems necessary or appropriate to implement the by-law provisions set forth in paragraph (c) above and shall:

(1) review no less frequently than annually such by-law provisions and further procedures for their continuing appropriateness, and

(2) review no less frequently than quarterly whether all transactions of Heizer during the

preceding quarter were effected in compliance with such by-law provisions and further procedures.

(e) Heizer shall maintain and preserve permanently in an easily accessible place a written copy of the by-law provisions and further procedures (and any modification thereto) described in paragraphs (c) and (d) hereof and shall maintain and preserve for a period of not less than six years from the end of the fiscal year in which any transactions occurred, the most recent two years in an easily accessible place, a written record of each transaction to which such by-law provisions or further procedures were applicable, setting forth the parties to such transaction, the terms of the transaction, and the information or materials upon which any determination described in paragraph (c) hereof was made.

HEIZER CORPORATION

By____________________________

STATE OF ILLINOIS)
) SS.
COUNTY OF COOK)

The undersigned being duly sworn deposes and says that he has duly executed the attached Application dated ____________, 1979 for and on behalf of Heizer Corporation; that he is the Vice President - Legal of such corporation; and that all action by stockholders, directors, and other bodies necessary to authorize him to execute and file such instrument has been taken. The undersigned further says that he is familiar with such instrument, and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.

____
John M. Lison

Subscribed and Sworn to
before me a Notary Public this
____ day of __________, 1979.
My commission expires ________
__________.

[NOTARIAL SEAL]

Pursuant to Rule 0-2 of the General Rules and Regulations under the Investment Company Act of 1940, Heizer Corporation declares that this Application is signed by John M. Lison, Vice President - Legal of said corporation, pursuant to the general authority vested in him as such by Section ___ of its By-Laws and by the resolution attached hereto as Exhibit _.

HEIZER CORPORATION

By______________________________
Secretary

DATED: Chicago, Illinois
__________, 1979

APPENDIX A

Definition of "business development company."

"Business development company" means any company that meets each of the following conditions:

(a) It is engaged or proposes to engage principally in the business of furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, or reorganizing companies or similar activities; and

(b) At least 80% of its net assets (exclusive of securities issued by such issuer, Government securities, short-term paper and other cash items) consists of securities which were:

(1) Acquired directly from the issuer thereof in a transaction or transactions not involving any public offering within the meaning of Section 4(2) of the Securities Act of 1933 or pursuant to the exercise of options, warrants or rights acquired in such transactions,

(2) Received in exchange for securities acquired pursuant to subparagraph (1) above in a reorganization described in sections 368 or 371 of the Internal Revenue Code of 1954, as amended, or in any exchange offer, or

(3) Distributed on or with respect to any such securities; and

(4) Issued by a person or any successor thereto (the "investee") more than 10% of whose voting securities became beneficially owned by the company as a result of the initial acquisition by the company of securities of the investee.

For purposes of subparagraph (4) above, a beneficial owner of a security includes any company which, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares (i) voting power which includes the power to vote or to direct the voting of, such security, or (ii) investment power which includes the power to dispose, or

to direct the disposition of, such security. A company shall likewise be deemed to be the beneficial owner of a security for purposes of subparagraph (4) above if that company has the right to acquire beneficial ownership of that security, as defined above, within sixty days, including but not limited to any right to acquire (i) through the exercise of any option, warrant or right or (ii) through the conversion of a security. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such company but shall not be deemed outstanding for the purpose of computing the percentage of the investee's securities owned by any other person.

EXHIBIT VII

ganized and they have even developed legislative vehicles of their own. Also, the burden for new legislation has shifted. Thanks to the actions of President Carter, it is the forces of unbridled development, not the forces of conservation, which cannot abide the status quo.

But, for all that has changed, the central issue in this debate remains the same and it is this: Will we surrender our Nation's last large holding of unspoiled land to untrammeled development and commercial exploitation, or will we, instead, learn from our past mistakes here in the "lower 48" and treat natural majesty with the respect it deserves? Will we finally meet legitimate needs for mineral extraction and other development in a balanced and rational way?

We were warned about the dangers of thoughtless exploitation of our natural resources by our first conservationist President, Theodore Roosevelt, who said early in this century that—

> We have become great because of the lavish use of our resources and we have just reason to be proud of our growth. But the time has come to inquire seriously what will happen when our forests are gone, when the coal, the iron, the oil, and the gas are exhausted, when the soils have been still further impoverished and washed into the streams, polluting the rivers.

He warned:

> These questions do not relate only to the next century or to the next generation. It is time for us now as a nation to exercise the same reasonable foresight in dealing with our great natural resources that would be shown by any prudent man in conserving . . . the property which contains the assurance of well-being for himself and his children.

But we as a people did not heed Theodore Roosevelt's words of some 70 years ago. Instead, we of the generation approaching the next century threaten our grandchildren with the same lack of foresight which bequeathed to us smog-choked cities, unfishable streams, and strip-mined lands. We may, with time and skill and at great expense, recover from the consequences of our past lack of foresight, but in Alaska, we have the chance—truly our last chance—to do things right the first time.

The opponents of the Udall-Anderson bill have leveled many charges against it, but one that I feel particularly compelled to address is this: that, in choosing Udall-Anderson over its competitors, we threaten to sacrifice our Nation's pressing energy needs on the altar of environmental extremism. This argument is directed especially at Members who represent such districts as mine. It is asked, As the representative of a commuting, suburban constituency, should you not be more concerned with harnessing the vital oil and gas beneath the Arctic National Wildlife Range than with protecting its herd of porcupine caribou? After all, the argument runs, your constituents use oil [illegible] few of them will ever even [illegible] caribou.

Well, I am concerned about energy. I am concerned that we utilize Alaska's [illegible] wealth—95 percent of which would be open to exploration and development under the Udall-Anderson bill. I am concerned, more importantly, that we work to develop new, alternative energy sources, such as solar and geothermal. But the essential fact remains, that, while there are alternative sources of energy, there are no alternative sources of porcupine caribou. And, while it is probably true that most of my constituents will never see a caribou, I do not believe—and I am convinced that my constituents do not believe—that we have the right to rob our children and our children's children of any possibility of ever experiencing that facet of nature's wonder.

The Udall-Anderson bill affords us the opportunity to exercise the kind of foresight which Theodore Roosevelt urged upon us nearly three-quarters of a century ago. In this House, we have frequent opportunities to do things for the benefit of one interest group or another in our society. But this bill affords us the rare opportunity to do something for a group of Americans who do not lobby us, cannot petition us, cannot even vote for us: the generations of Americans yet unborn. They cannot vote for us, but I am confident that they will remember us well if we act in their interest today. I strongly urge support for the Udall-Anderson Alaska lands bill so that we can do it right the first time—for them.●

□ 1935

The SPEAKER pro tempore (Mr. GEPHARDT). Under a previous order of the House, the gentleman from Vermont (Mr. JEFFORDS) is recognized for 10 minutes.

[Mr. JEFFORDS addressed the House. His remarks will appear hereafter in the Extensions of Remarks.]

THE SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1979

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from North Carolina (Mr. BROYHILL) is recognized for 10 minutes.

● Mr. BROYHILL. Mr Speaker, if you ever need to transport a small package to another section of the country in a hurry, you may rely upon a company called Federal Express which specializes in overnight package deliveries. Federal Express "went public" in April of 1978 and within a very few months its common stock was trading at three times its original public offering price. Federal Express is a wildly successful new company and one of the most successful venture capital investments of the 1970's. The intriguing story, however, is that of the events which transpired before the company went public.

The highest risk takers in Federal Express, as in many other small and start-up endeavors, were the venture capitalists who provided the equity capital needed to get the company off the ground. That group of investors worked hard to help Federal survive—it was close to bankruptcy on at least two occasions in its early life. The venture capitalists, all [illegible] and acting in concert pursuant to the private placement exemption provided by section 4(2) of the Securities Act of 1933, supplied three rounds of equity financing before the company went public. In exchange for their private financings they received what the Securities and Exchange Commission refers to as "restricted stock." As a result of their actions, the venture capitalists gave birth to an exciting new enterprise. They were, however, left with equity securities less liquid than those purchased by public investors when Federal Express went public.

The Securities Act of 1933, in section 4(2), provides an exemption from registration for stock offerings which do not constitute a "public" offering. Pursuant to that section, the SEC drafted rule 146 which allows sophisticated individuals and individuals of substantial net worth to invest (generally in groups not to exceed 35) in small and new ventures under the rule 146 "private placement exemption."

Although this rule works reasonably well going into an investment, it places undue burdens on investors after they make an investment, since liquidity (or resalability) is severely impeded.

An investor proceeding under the private placement exemption receives "restricted stock," which means that he is severely restricted in the manner in which he sells those securities.

He is generally bound by rule 144, which currently allows him to sell only 1 percent of the outstanding securities of that class in any 3-month period (or the average weekly volume over the preceding 4-week period, whichever is greater).

Thus, the liquidity restrictions which ultimately result from private placement stock offerings have unduly hindered the venture capital formation process in our country today.

Traditionally, much equity capital for new and small ventures was provided by wealthy individuals and the smaller public investor. Unfavorable tax treatment during the past decade, however, caused wealthy investors to employ their funds elsewhere.

That tax situation plus a general lack of confidence has driven the small investor from directly purchasing stock of new and small companies via the public stock market. What has developed, however, is a new market structure dominated by institutional investors.

The Small Business Investment Incentive Act of 1979 is a proposal whereby the institutional investor can invest in new ventures without going the unnecessary and expensive route of making a public offering under the Securities Act of 1933 and whereby the smaller investor can invest in professionally managed venture capital funds with certain safeguards.

Guarded protections must be provided for small, unsophisticated and vulnerable investors. The Small Business Investment Incentive Act does not [illegible] we do away with these protections, but rather that impediments confronting those investors who are able to fend for themselves be [illegible] [illegible] with regulations currently preventing small investors from investing in professionally managed venture funds, thus allowing more capital to flow into exciting new enterprises. With the Small Bus-

ness Investment Incentive Act as law, sophisticated investors would have impediments removed and the small companies seeking capital would be able to receive that capital more cheaply.

In addition, smaller investors would be able to invest in professionally managed venture funds. For the public investor who needs protection, however, all disclosure requirements for securities trading in the public markets would remain intact.

Furthermore, the broad and effective antifraud provisions of the Securities Exchange Act of 1934 would apply to anyone dealing fraudulently in securities markets regardless of whether those dealings are public or private transactions under the 1933 act.

Thus, the Small Business Investment Incentive Act would not interfere with the legal remedies currently available to the investor who has been defrauded.

The Small Business Investment Incentive Act is not intended to be an end-all solution for the problems which plague the venture capital markets. We must remember that capital formation is a complex subject and the hindrances to U.S. capital formation are many and varied. The Small Business Investment Incentive Act of 1979 is, however, a major step in the direction of reducing the current "constipation" in the venture capital markets. It will optimally balance the equally desirable objectives of venture capital formation and investor protection.

I am submitting for the Record today a section-by-section analysis of the Small Business Investment Incentive Act of 1979, along with the language of the bill.

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

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 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).".

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.

THE SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1979—SECTION-BY-SECTION ANALYSIS

Section 1. Title.

Section 2. Exemptions from Securities Act of 1933. This section exempts a sale of securities from full registration under the Securities Act of 1933 if all purchasers of the stock are accredited investors provided there is no general advertising or solicitation in connection with the transaction.

Section 3. Definition of Terms. This section defines "accredited investor" as any financial institution or "fund, trust, or other account" administered by a financial institution, any person designated by the Commission as an accredited investor based upon such factors as financial sophistication, net worth, or business experience, or any other person who may not qualify as an accredited investor under Commission rules but relies on the advice of someone who does.

Section 4. Resale of Restricted Securities. This section provides that no limitation on the resale of restricted securities shall apply after a purchaser has held the securities for a period of five years or more. The need for this section arises from the fact that the Commission does not feel that it can exempt affiliated holders of restricted securities from the resale provisions as currently allowed nonaffiliates under Rule 144. (Restricted securities are those which have been purchased under conditions which did not constitute a public offering under the Securities Act of 1933. Rule 144 currently allows the resale of such securities after a two-year holding period at a rate equal to one percent of the outstanding securities of a class in any three-month period, or the average weekly trading volume over a four-week trading period immediately preceding such resale, whichever is greater.)

The Commission currently exempts nonaffiliate holders of restricted securities from the above resale limitations after a three or four-year holding period, depending upon which market the security is traded on. The Commission does not feel, however, that it has the power to exempt affiliates from such restrictions since such persons may be acting as underwriters as defined under the 1933 Act. Because a person who invests for a period of five years shows investment intent (in contrast to an underwriter who is in the business of turning over his money rapidly), the bill would remove limitations

on resale of restricted securities by affiliates after this period.

Section 5 Liability in Private Offerings. This section limits the right of rescission for purchasers of securities Currently under Section 4(2) of the Securities Act, a purchaser of securities issued pursuant to a limited offering may sue for his investment if he does not meet the tests of sophistication or substantial net worth or if he was not provided with all material information by the issuer of such securities. Under existing law, however, the entire offering may be collapsed since all purchasers are then granted standing to sue. Section 5 would bar other purchasers from recovery unless they too could prove 1) that they did not receive all material information or 2) that they could not, at the time of the offering, meet the tests of sophistication or net worth and that that was a condition the issuer should have been aware of.

Section 6 Exemption from the Investment Company Act of 1940. This section exempts venture capital companies from the Investment Company Act of 1940. The Investment Company Act of 1940 was passed to regulate abuses in the mutual fund industry such as unscrupulous managers who had large amounts of cash which could be quickly shifted and manipulated to the detriment of the outside investors.

Venture capital companies, however, do not purchase stock on public markets but rather make private investments directly in small businesses. Such investments are highly illiquid and are often held for periods of up to ten years or more At the time the Investment Company Act of 1940 was passed, however, there were virtually no venture capital firms in existence which were publicly traded Had there been such firms in existence it may very well have been discovered that the provisions of the Investment Company Act of 1940 were unnecessary.

Section 7. Effective Date. Effective date of enactment and prescribed period for the promulgation of rules and regulations by the Commission ●

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Oregon (Mr. WEAVER) is recognized for 10 minutes.

[Mr. WEAVER addressed the House. His remarks will appear hereafter in the Extensions of Remarks.]

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Illinois (Mr. ANNUNZIO) is recognized for 5 minutes.

[Mr. ANNUNZIO addressed the House. His remarks will appear hereafter in the Extensions of Remarks.]

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Texas (Mr. GONZALEZ) is recognized for 5 minutes.

[Mr. GONZALEZ addressed the House. His remarks will appear hereafter in the Extensions of Remarks.]

MEDICARE IMPROVEMENT BILLS

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from New York (Mr. RANGEL) is recognized for 5 minutes.

● Mr. RANGEL Mr. Speaker, as chairman of the Subcommittee on Health of the Committee on Ways and Means I am today joining several of my colleagues on the subcommittee in introducing two bills which would provide for a number of administrative and benefit improvements in the medicare program. These bills are identical to legislation reported in the previous Congress by the Committee on Ways and Means and approved by the House of Representatives—H.R. 13097 and H.R. 13817. Had there been sufficient time remaining in the session, I am confident that the Senate would have acted favorably on both of these bills.

I am introducing these bills because the Subcommittee on Health has agreed to consider this year legislation along the lines of the bills developed last year. I would want to make clear, however, that in sponsornig the legislation, I am not suggesting that the subcommittee's deliberations will be limited to the provisions of these two proposals. I expect that the members of the subcommittee will have additional amendments they will want to have considered; and I also expect that we would consider the medicare amendments recommended by the President in his fiscal year 1980 budget recommendations. Although we do not have specific dates scheduled, I anticipate that the subcommittee will be holding hearings on a wide range of possible medicare amendments shortly after we have completed our work on the President's proposal for hospital cost containment.

Although the subcommittee will be taking a fresh look at the provisions included in last year's bill and examining other amendments for possible inclusion, I expect that the legislation recommended by the subcommittee will be very similar in scope to the bills developed last year. As Members will recall, the subcommittee, in developing that legislation, was conscientious in conforming to the rather tight budgetary limitation imposed by the congressional budget resolution. And, it is likely that we will be working under similar budgetary limitations again this year.

I am eager to begin working on the development of the legislation and I am confident that even though we will once again be limited to relatively low-cost provisions, we can do much to make the medicare program more responsive to the needs of beneficiaries.

SUMMARY OF THE MEDICARE AMENDMENTS OF 1979

Section 2.—Home health services.

The medicare home health benefit would be liberalized in the following manner: (1) unlimited visits would be available under both parts A and B of medicare; (2) the present three-day prior hospitalization requirement under part A would be eliminated; (3) home health benefits under part B would no longer be subject to the $60 deductible; and (4) the present requirement that proprietary home health agencies be licensed under state law in order to participate in medicare would be eliminated

In addition the Secretary of HEW would be provided authority to establish additional standards and reimbursement guidelines for the effective administration of the home health benefit; home health aides would be required to complete an appropriate training program, the Secretary would be directed to designate regional intermediaries for home health agencies, and the Secretary would be authorized to establish such other administrative requirements as he finds necessary for the effective and efficient operation of the program

Section 3.—Elimination of the second waiting period for reentitled disability beneficiaries.

Entitlement to medicare benefits would be provided for individuals who have been entitled to disability payments for a total of 24 months, regardless of whether those 24 months were consecutive In that way, an individual who has satisfied the 24-month requirement and attempts unsuccessfully to return to work would be immediately entitled to medicare benefits when he resumes receiving monthly disability benefits.

Section 4.—Reciprocal agreements for coverage outside the United States.

The President would be authorized to enter into reciprocal agreements with other countries to provide hospital and medical benefits to medicare beneficiaries living or travelling outside the United States.

Section 5.—Dentists' services.

Services performed by dentists would be covered if the same services are covered when furnished by physicians Also, hospital stays for the performance of a noncovered dental service would be covered where the severity of the dental procedure warrants hospitalization Coverage for routine dental services would continue to be excluded.

Section 6.—Treatment for plantar warts.

The present exclusion of services related to treatment of plantar warts (warts on the feet) would be eliminated.

Section 7.—Community mental health centers.

Services provided in qualified community mental health centers by physicians or other qualified personel would be reimbursed under part A of medicare on the basis of the cost incurred in providing the covered services A total of ten outpatient visits per year would be covered and up to 60 days of partial hospitalization. Beneficiaries would exchange one day of their 190-day lifetime limit on outpatient psychiatric hospitalization for every four days of partial hospitalization in a community mental health center. Mental health services provided by a community mental health center would not be subject to the part B deductible, coinsurance, or $250 yearly limit applicable to outpatient mental health services furnished by psychiatrists or other M.D.'s.

Section 8.—Comprehensive outpatient rehabilitation centers.

Certain comprehensive outpatient rehabilitation centers would be recognized as providers of services under medicare Such rehabilitation centers could be public or private institutions primarily engaged in providing diagnostic therapeutic, and restorative services to outpatients that meet specified conditions of participation.

Section 9.—Optometrists' services.

Services furnished by optometrists in connection with treatment of aphakic patients (patients without the natural lens of the eye) would be covered. Also, the Secretary would be directed to report to the Congress within nine months as to specific legislative recommendations for implementing coverage for services furnished by optometrists for treatment of cataracts.

Section 10.—Demonstration projects for Hospice services.

The Secretary would be directed to conduct a demonstration project to acquire necessary information and data with respect to reimbursement for hospice services under medicare.

Mr. BROYHILL. Thank you, Mr. Garrett.

It was suggested yesterday in testimony by the panel from the SBIC's that the 1940 act was so burdensome they would be glad to register under the 1933 and 1934 acts in order to get out from under the 1940 act. What would be your reaction to that?

Mr. GARRETT. The exemption certainly should be further conditioned upon the exempt company being registered under the Exchange Act. All of our thinking in this area assumed that it would be. If a venture capital company with a public market that was not a 1934 act company could exist, it ought not to be permitted.

Mr. BROYHILL. We have had some testimony here that would disagree with the definition of a venture capital firm, the organization that is contained in this bill, H.R. 3991.

Could you help us define what a venture capital firm should be?

Mr. GARRETT. In terms of its conduct of its business, I am very doubtful that you can do a better job. The language in H.R. 3991, of course, is taken, with some modifications, from the act itself; from section 12, which deals with investment company pyramiding.

We tried and the SEC staff has tried too. In their proposed rule 205-3 under the Investment Advisers Act, they define the kind of company—what they call a business development company—that can pay a performance fee to its adviser, under certain conditions. We objected rather strenuously to that definition. They tried to impose limitations with respect to the size of an issuer in which investments may be made, a so-called investee company—its earnings, its assets, the lack of a public market for its securities and its lack of 1934 act registration.

I think the more you try to do that, the more you are likely to come to the conclusion, as we did, that it is the wrong road to go down.

First of all, from the Commission's point of view, I don't know, to be a little flip about it, what business they have deciding what kinds of companies are worthy of investment as against what kinds of investor protections should be given up. If you put dollar limits in the definition, you are almost certain these days, fairly certain, to be out of date pretty soon. If you put in other obstructions, you may not anticipate the things that you are cutting out. For example, the fact that an investee company must not be registered under the 1934 act initially sounds good—it doesn't have any public market. But some of the most interesting turnaround situations are companies that did start out in one line of business, did have a public market, are 1934 act companies, but their original line of business is kind of pooping out and they develop some new management, some new ideas, and the venture capital company wants to come in to help them out. This is true of one or two of the situations that Heizer Corp. is involved in and I don't see any logical reason to categorically cut them out.

Also, I think it reflects the wrong philosophical approach; that is to say, I don't think either the Commission or the Congress ought to be engaged deliberately in the exercise of saying that we love small business and we will tell you which small businesses we love, and we are willing to throw small investors to the dogs in order to help those small businesses. I don't think that is the right way to get at this problem.

The right way to get at it is to define the exempt company so that you do not have dangers of abuse to investors that are significantly different from those that exist with any other company whose securities they can buy. Once you have done that, then there is no reason to say, "Well, you need the extraordinary ministrations of the 1940 act." Your investors can get along like everybody else that invests in corporate securities; there is no reason why they shouldn't.

I realize we wouldn't be engaged in all this if we didn't want to provide more capital for small business, but I do not encourage any attempt to go down the road of trying to decide what kinds of small businesses are good and count, so to speak, and what kinds aren't, because you probably would end up saying, "Well, we better leave it up to administrative agencies that can watch the situation from time to time." If you watched the SBA try to decide over the years what is small and things of that sort, I think it would discourage you from wanting to do that at all. And I do not think it is necessary.

Mr. BROYHILL. At one time you attempted to help me come up with a list of regulatory legal impediments to the proper operation of a venture capital firm under the 1940 act. I wonder if you could do that for me again and we would hold the record at this point to include that.

Mr. GARRETT. I believe our December 1978 memorandum, which was responsive to your request at the September 1978 hearings, is about as comprehensive a job as we can do, Mr. Broyhill. If there is something there that needs explanation or elaboration, we would be glad to furnish it.

Mr. BROYHILL. I will at least refer to it for the record, pages 49 through—it is rather long.

Mr. GARRETT. Well, if you could find the typewritten copy that was delivered to you, you would find the exhibit in living color, which is quite vivid, but the color didn't survive the Government Printing Office. We can summarize it for you, if that would be helpful, cut it down to a few pages.

Mr. BROYHILL. Page 49 through page 227 of the hearings conducted on "Small Business Investment," September 27 and 28, 1978, and——

Mr. GARRETT. Would a more digestible summary be helpful to you?

Mr. BROYHILL. That would be fine.

Mr. GARRETT. Surely. Be glad to.

[The summary was subsequently received and retained in the subcommittee's files.]

Mr. BROYHILL. Mr. Opper?

Mr. OPPER. I suppose the most difficult hurdle in finding a solution to the venture capital company problem, or which there seems to be universal agreement is real, is, as we continue to discuss it, the definition of a venture capital company.

The testimony we received in the last 2 days seems to say, Mr. Garrett, that venture capital companies, as distinguished from other kinds of closed-end companies, ought to be exempt because they are really performing in a much different way than the garden variety closed-end fund.

They become involved sometimes in the management of the portfolio security companies; they require quite a bit of flexibility with respect to structuring securities acquisitions, whether it be equity kickers, senior securities, or other kinds of embellishments beyond normal common stock.

In addition, management needs in many cases such things as the kind of incentive arrangements that the 1940 act really prohibits. To structure a definition of a venture capital company that would include these kinds of companies, the kind of company which Heizer and other generally recognized venture capital companies are, without including the many other kinds of closed-end funds is difficult because it seems that any kind of definition would include closed-end funds that may not be doing any of these things.

Mr. Mann previously suggested it might include letter stock funds. I am not sure that that would necessarily qualify under anyone's definition as a venture capital company.

Mr. GARRETT. It shouldn't, and if the worry is severe, there may be further language, very simple language, if we think about it, that would exclude these others.

I don't think it is much of a problem to exclude money market funds from the exemption. You also have to consider the tax laws, and the money market fund, for example, can't run on a taxable basis and is certainly going to want the exemption provided by subchapter M of the Internal Revenue Code which it is not going to get unless it is registered.

Mr. BROYHILL. Would you yield at that point?

I am not quite sure how you could run a money market fund under this definition since the words say that "these are securities of issuers for which there is no ready market in existence."

Mr. GARRETT. I agree with you.

The worry, however, is based upon the peculiarities of the commercial paper market.

Mr. BROYHILL. Isn't there a ready market for commercial paper?

Mr. GARRETT. There better be, if you are the only person that is an available customer——

Mr. BROYHILL. I could assume that there may be certain securities of certain companies that may not have a ready market; but there is a market at least for those types of securities.

Mr. GARRETT. It is even arguable whether buying commercial paper is furnishing capital or financing.

Mr. OPPER. Well, the Commission has made this observation and apparently is relying upon other provisions of section 6, aside from the one that Chairman Broyhill referred to.

If we could focus a moment on Heizer Corp. There is a certain irony involved because of Heizer Corp. phenomenal success. As I understand it 80 percent of the dollar value of your present portfolio as represented by New York Stock Exchange listed companies. These are not normally the kinds of investments which we think of when we think of venture capital companies.

As you have explained, you have not, because of the Investment Company Act and other reasons, been able to do any new deals, and that has affected your turnover. Any time you are as successful as you have been you might run into this problem.

55-753 O - 80 - 31

That creates another kind of definitional problem for us, because you are a mature company which looks very much like the traditional closed-end investment company, and not the venture capital company presumably you want to be in the future, once we hopefully resolve this problem.

I don't know, but that seems to create another dimension to the problem.

Mr. HEIZER. It seems to me, Mr. Opper, that that really should not bother you, because the issue should be protecting the public. If you take the type of legislation Mr. Garrett was talking about, the public is still protected. It does not need the 1940 act.

In other words, we bought all of these securities in private transactions in orderly stages, and we will distribute them in time under our plan. If we were public, we would distribute on a tax free basis, as do other mature companies, as we went along.

Mr. OPPER. Perhaps the definition could relate back to some period of time when you acquired the security.

Mr. GARRETT. Well, at some point you have got to be able to establish the case with the lawyers at the SEC that you are primarily engaged in the business of furnishing capital. If, as Marty Lybecker has imagined, or as the Commission's comments on H.R. 3991 suggests, you bought IBM and Polaroid when they were young and now they look great and you just sit there and hold them, at some point you can't make that case. Also, at some point, unless your shareholders are real inattentive idiots somebody is going to be suing you, because there is no economic advantage in having an intermediate corporation sitting there doing nothing more than holding securities of listed companies. They could not manage the portfolio under the restrictions that are in the Senate bills, and they could not buy and sell and play around with their portifolio securities. In addition, there would come a point when such an entity could no longer claim it was principally engaged in this business.

Your question also provides a good illustration of the difficulties in trying to define what is small. You simply cannot be an IBM competitor in the manufacture of major basic computer hardware and be talking about a few hundred thousand dollars. It is tiny if you compare it with IBM; but if you compare it with other small businesses it's a pretty big company.

Mr. OPPER. Would you leave the definition of "primarily engaged" up to the Commission or would you want to define that in the statute?

Mr. GARRETT. I would not have it defined either place.

Mr. OPPER. By what standard would that issue be determined?

Mr. GARRETT. It would be defined when the Commission or some investor challenged the companies entitled to this exemption.

Mr. OPPER. Wouldn't it be preferable to offer some guidance as to what "primarily being engaged in the business" means?

Mr. GARRETT. Well, there is a fair amount of case law now under the 1940 act and some of the other exemptive provisions and elsewhere with respect to what "primarily" means, and that is what got into the Senate bills. Both "principally" and "primarily" are used in different parts of the 1940 act, and they tend to throw the balance different ways. It is possible to give the Commission ex-

press rulemaking power in this area, but I really don't think it would be constructive.

Mr. HEIZER. The irony you are speaking of cuts both ways, because if all the company was going to do was sit and hold mature securities then operating under the 1940 act would be no problem and you would have the simple tax throughput provisions.

Indeed, that is what caused a lot of companies 10 years ago to try to, through mutual funds, to hold their securities. The irony of Heizer Corp., as you put it, because we haven't been doing new deals for 5 years, we are now mature. We have to be mature in order to liquidate.

If we were not going to continue on in the base business where these companies developed from, then the 1940 act would be no problem.

Mr. GARRETT. I might say also that, even though legislation does not come as rapidly as rule changes could come and sometimes do come, this would strike me as an area in which it would be wiser to, if this should prove to be the case, overshoot the mark and at least get a bracket on the problem rather then sneak up on it.

Right now we have got investors so protected that they don't exist. We ought to create some. If it turns out that under the legislation you have got some very ingenious thieves abusing the exemption and running funds that were never intended to be included and abusing their shareholders, I presume that remedies could be found through legislation, and I have a great deal of respect for the ingenuity of the Enforcement Division of the SEC.

I would imagine that they could do a lot with what "primarily engaged" means in an enforcement action.

Rather than thinking about every possible ghost under the bed, because we don't have any right now, we ought to go forward with this legislation and then deal with abuses if some do develop on the periphery.

Mr. BROYHILL. Mr. McMahon, do you have any other questions?

Mr. Opper?

Mr. OPPER. No.

Mr. MCMAHON. One quick question.

You mentioned earlier in your testimony that you anticipate some sort of resolution by the SEC of Mr. Heizer's particular problem.

I would like to know what would be the precedential value of that particular decision?

Mr. GARRETT. An SEC exemptive order presumably would be based on general principles and not entirely upon how Mr. Heizer parts his hair. On the other hand, it would be based upon consideration of a specific situation that we have worked out with the staff. Here, I must second what Mr. Heizer said; the staff has devoted a great deal of effort to study of the problem, has responded quickly and has shown a genuine willingness to work with us.

We have worked out a rather cumbersome and elaborate resolution of the section 17 problem dealing with selfdealing, dealings with affiliates and things of that kind, involving the presence of an outside board of directors and their passing upon these things.

We have even worked out what we think is a pretty good solution to inadvertent transactions in this area. We are now hung up

on several things, but one of the most critical, looking down the road to what we might need, is the 1940 act's prohibition against convertibles and options and warrants.

If we got those exemptions, could the next company come in and say, well, we are like Heizer, and we want those same exemptions, will you give them to us.

First of all, they may or may not be like Heizer in some respects. In addition, you don't know whether the same staff people will be there and you don't know whether the Commission is going to be the same, so you have all of those things to worry about.

An exemptive order should be like a legal decision—something you could draw upon as precedent, arguing that you are entitled to the same thing the other fellow has gotten. But it is by no means automatic. And because an order does deal with a specific applicant, it is not difficult, if the staff finds it necessary, to find discrepancies between what the other guy got and what you get. It does not strike me as an adequate basis to encourage another businessman to form a new venture capital company and to represent to his investors that it will be able to get an exemptive order and go public at an appropriate time.

Mr. McMahon. Thank you very much.

Mr. Broyhill. Thank you, gentlemen.

You have been very helpful to the committee.

Mr. Heizer. Thank you very much.

Mr. Broyhill. Mr. Chambers, we are delighted to have you here, and I apologize for keeping you so long.

I thought we would get through by 1 o'clock. I thought we would go ahead instead of breaking it up. Because you are last doesn't mean your testimony isn't important.

STATEMENT OF FRANK G. CHAMBERS, PRESIDENT, CONTINENTAL CAPITAL CORP.

Mr. Chambers. In view of a few growling stomachs I will summarize and answer your questions.

By way of background, I have been a venture capitalist for the last 33 years since World War II. For the last 20 years I have been a full-time venture capitalist as president of Continental Capital Corp. which an associate and I founded in 1959.

We have made over 100 equity investments; 45 of them have been startups and I would suppose this is a record number of startups. I have been involved in a number of other startups on a personal basis, but of the survivors of those 45 companies, they now have sales in excess of $500 million. They make profits of over $50 million before taxes, and they pay over $25 million in Federal taxes and they employ over 10,000 people.

This has been accomplished with $5½ million and two public underwritings of which we have returned $4¼ million, so the capital remaining in Continental Capital Corp. is only $1¼ million.

Certainly, this has to be a contribution to society.

Mr. Broyhill. Is this exclusive of dividends or other return to shareholders?

Mr. Chambers. Well, we have paid back in two capital distributions to our shareholders totaling the $4¼ million. We are a capital gains organization and have not paid ordinary dividends during

that time. I think this is an indication of the significance of venture capital to our society and to our future.

Yet in the face of this record, on August 31, our shareholders voted overwhelmingly to cease operations and distribute the assets because of two things: The double taxation at the corporate level and the onerous burden of the SEC regulation.

I find this a rather astonishing bit of evidence. I was not in attendance yesterday and some of those figures may have been recited, but there have been 102 publicly held SBIC's subject to the 1940 act regulation. There are now 32 on the rolls, but only 15 are actively traded.

Of that 15 only Continental has specialized in high technology investments, and with the result of our liquidation there will not be one single publicly traded SBIC in this Nation specializing in high technology startups in which the small investor can invest. We intend to go on.

The principals of Continental intend to go into partnership form using institutional money and our own funds. We will have a substantial stake in the limited partnership, but the individual investor will not be able to participate in our new venture.

In my opinion, the SBIC Act of 1958 was a highly perceptive piece of legislation, and in my opinion if the drafters of that had envisioned that we would be subject to the 1940 act and dual regulation and subject to double taxation, they would have written in the original act exemption which would have prevented the present problem with which we are dealing.

It would be proper for you to say, what have you tried to do about it? We have tried to do a lot of things about it. NASBIC has been working on this for many years. I have talked with Senator Williams, with Walter Stults, and he said he would look into it.

He called the then Chairman Garrett who we were happy to have give this kind of testimony here today, who said he would look into it and he could handle it administratively. Well, he left the Commission before it got handled administratively, so we have continued to be regulated by a bill which was passed 40 years ago to regulate a completely different kind of organization than we are.

The situation is certainly that the SEC is peopled by intelligent, educated, vigorous young lawyers, by and large, who are not experienced in small business. They are not experienced in venture capital or in the nature of the entrepreneur, so I liken it to trying to play baseball by football rules using basketball officials.

There is no communication, no understanding with our kind of vehicle. Furthermore, it has required every single decision that we have made to be considered in light of the 1940 act implications, and this has been an expensive and frustrating experience.

Let me give you just capsules of three things that have happened to me, to us, with the SEC.

When we wanted to raise additional money in 1969 we filed our registration statement. They questioned whether or not it was sufficiently complete and they said that it should include what amounted to registration information on each one of the 24 companies then in our portfolio.

Well, our lawyers gave up. They could not convince them that that was illogical, so I came back and met with the SEC staff,

found two camps completley at odds with each other on that subject, but I pointed out if we had to disclose information on privately held companies we would be in violation of really a trust and that we couldn't do it, in fact wouldn't do it, and I was going to withdraw the registration statement.

They said, well, you have been successful for 10 years, and we will relent in this one case. Within the last year we have been audited by the IRS, the SBA, and the SEC, within 5 months, 27 man-days spent in our office.

The SEC auditors arrived without an appointment, without advance notice of their intended visit, and they spent 14 days. I don't know how much they spent outside auditing our five-man organization.

Finally, when we made the decision to liquidate and file our draft proxy statement, no action, no word was heard for 10 days. Our counsel then called and that resulted in efforts to agree upon words for another couple of days, at which time they said their accounting staff wanted to have a detailed review of the financial information.

Well, you, I am sure, realize that we had filed semiannual reports in N-5 R and 468's, and our audited financial statement with the SEC.

They had 40 reports over 20 years and had spent 14 days auditing us, and they still want to audit the financial information. Well, this wound up with an all-day conference call on a Friday, and we had a deadline because of a closing transaction which would have subjected us to $400,000 in additional taxes if we didn't hold that meeting on that day, and at 3:45 California time they signed off to their credit.

They were willing to work that late and we went to press overnight on Friday, mailed the proxy statement on Saturday, and on Monday morning at my home I received a telephone call from a member of the Disclosure Policy and Review Division, asking if this was a final proxy statement and I said yes.

He said, "Has it been mailed?", and my reply was affirmative.

He said, "We will then have to consider going to court and getting an injunction to prevent you from having your special stockholders meeting."

I replied that I would, if they did that, be in Chairman Williams' office the following morning, and with that they went back to the telephone with the lawyers and, another day, that resulted in a new proxy solicitation with two pages of additional information.

That resulted in approximately a dozen telephone calls inquiring as to why we were doing this, and it clearly had resulted in confusion rather than enlightenment. Of course, it cost us another $5,000 or so in additional mailing, printing, legal costs to do this and all of this to absolutely no avail.

The vote in our special shareholders meeting was 69.08 percent in favor of dissolution, 2.09 percent against. Obviously, we are not going to be subject to the 1940 act anymore and you could say, why am I here?

Well, my associates and I believe that our record shows how immensely valuable professional visible venture capital can be, and creating an environment which the entrepreneur can obtain finan-

cial support and the kind of counsel we can provide serves a vital national purpose.

Fostering pioneering should have top priority in both Government and our society. The individual investor now has no place to go, and to me this is indeed sad.

The SEC regulations have had a major role in bringing about the end of the majority of public SBIC's in the 20 years since the act was passed.

SBIC shareholders have been protected into extinction and we believe that this damaging and unhealthy situation should be changed, and that it should be corrected by exempting public SBIC's from the dual regulations of SBA and SEC and SBA be permitted to do the entire regulating job.

[Mr. Chambers' prepared statement follows:]

November 8, 1979

TESTIMONY OF

FRANK G. CHAMBERS, PRESIDENT

CONTINENTAL CAPITAL CORPORATION

BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE

CONTINENTAL CAPITAL CORPORATION was founded in April of 1959, one of the first licensed under the SBIC Act of 1958. In these twenty years, more than 100 equity investments were made in young enterprises, 45 of them start-ups. The survivors of these start-up companies now have combined annual sales exceeding $500 million. They employ more than 10,000 people, they generate pre-tax profits of over $50 million, they pay $25 million in taxes, and have in excess of $25 million available for reinvestments and dividends.

The original net capital of $5.5 million in Continental, raised in underwritings of $3 million in 1960 and $2.5 million in 1969, is now only one and a quarter million dollars after two pass-throughs totalling $4.25 million to shareholders. Thus, an exceedingly modest amount of capital has made truly significant contributions to our country.

On August 31, 1979 Continental's shareholders voted overwhelmingly to distribute the Corporation's assets and cease operation. The market price of Continental's shares immediately almost doubled. This could only mean that the cost of double taxation at the corporate level, and the onerous burden of SEC regulations, was nearly 50% of the company's net worth. Is this not astonishing evidence?

One hundred-two SBICs have been subject to regulation under the Investment Company Act of 1940. Only 32 remain and of those only 15 have shares actively trading. None of these, except Continental Capital, specializes in start-ups. As a result of Continental Capital's liquidation, there will be no publicly-traded, professionally-managed venture capital companies left affording small shareholders the opportunity to invest in start-up ventures.

The principals of Continental Capital will establish a private partnership which will make the same type of start-up investments in high-technology companies as they have been doing for the past twenty years. Why then have I traveled from San Francisco to Washington to appear before this Committee?

The Small Business Investment Company Act of 1958 was a highly perceptive piece of legislation. Certainly none of the drafters envisioned that public SBICs would be subject to the '40 Act which obviously would involve duplicate regulation by the SBA and SEC.

The National Association of Small Business Investment Companies (NASBIC) and various SBICs, including Continental, have made numerous efforts during the past twelve years to have SBICs exempted from the dual regulation of the SBA and the SEC. For example, Mr. Stults of NASBIC and I met with Senator Harrison Williams in 1975 and explained the problems we faced with SEC regulation under the '40 Act.

Senator Williams phoned Chairman Garrett. Mr. Garrett told Senator Williams that "the situation would be handled administratively and that it was not a large enough problem to justify legislation." Shortly thereafter, before Chairman Garrett could act, he left the Commission, and nothing was done to alleviate the underlying problems. The regulation of publicly-held SBICs was perpetuated with rules designed forty years ago for mutual funds, which SBICs clearly are not. The situation is closely akin to applying basketball rules to a football game using baseball umpires as the officials. The SEC regulation has not only been a major cause of the demise of the majority of the 102, 1940 Act SBICs, it also has effectively prevented new publicly-held SBICs from being established. It has required us to study the '40 Act implication of every investment decision we have made. This has been an expensive and frustrating burden, with no useful purpose served.

Following are specific instances which illustrate our frustration.

In 1969, we decided to raise additional capital of two-and-one-half million dollars. Our draft registration statement brought forth major policy differences between various individuals within the SEC. Our attorneys eventually concluded they could not bring about a resolution of these differences within the SEC which had stalled our underwriting. I traveled to Washington and met with the SEC staff. One SEC group insisted that we should

provide basic registration information statements on each of our two dozen companies. This, of course, would have been tantamount to 24 registration statements. We would have had to disclose confidential information since many of the companies were privately held. It would have been a breach of confidence which we could never permit. When I refused and said I would withdraw our statement, the SEC staff reluctantly relented, in view of our highly successful ten-year history.

Within five months in the last year, we have been audited by the IRS, the SBA, and the SEC. Twenty-seven man-days of government time in our office were devoted to auditing our five-person organization. The IRS and the SBA auditors called and made appointments. The SEC auditors, however, arrived without notice or appointment; they were responsible for 14 of the 27 man-days spent. All audits were routine. None resulted in other than trivial questions.

Our draft proxy statement relating to the Special Meeting of Shareholders to be held on August 31, 1979, to vote on the distribution of assets of Continental Capital was filed with the SEC on July 20, 1979. As we did not hear from the Commission, our counsel called on August 1, 1979. At this stage, after several days of effort, when the specific wording had been agreed upon, our counsel was then informed that the accounting staff now wished to make an in-depth study of the financial data, though the SEC files contained 20 years of Forms N-5R and 468's, and our audited

financial statements. Further, we were audited by the SEC in April 1979 as stated earlier. This resulted in two more days of conference calls, and, ultimately, at 3:45 p.m. California time on Friday, August 3, the final call was concluded, and the proxy statement was sent to press overnight, with a Saturday mailing arranged, since the August 31 deadline was crucial to closing of the sale of one of our investees, scheduled for September 5th. To miss the August 31 date would have resulted in a tax cost of approximately $400,000.

The following Monday morning, August 6, I received a call at home from a member of the Disclosure Policy and Review Division of the SEC: "I have in my hand what appears to be a final proxy statement. Is it?" My answer was affirmative. He asked whether "it had been mailed?" Once again, my answer was affirmative. He then stated that "they would have to consider going to court to obtain an injunction to prevent our having our special shareholders meeting." I informed him that if he took that action, I would be in the office of Chairman Williams the following morning. An entire day was then spent in a series of conference calls with various members of the SEC's staff. The result was two pages of supplemental information and a second proxy solicitation, - this on the 17th day after our draft proxy material was filed. The cost of this second solicitation exceeded $5,000. The supplemental information resulted in approximately a dozen phone calls requesting an explanation of what it meant. Clearly, it confused rather than enlightened. The vote at the Special Meeting of Share-

holders was 69.08% in favor of dissolution; 2.09% against.

My associates and I believe our record shows how immensely effective visible venture capital can be. Creating an environment in which the entrepreneur can obtain financial support and the kind of counsel and help we can provide serves a vital national purpose. The fostering of pioneering should, we believe, have a top priority in both government and society. The individual investor, with the departure of our corporation, will not have one single place to go to invest in a venture capital organization devoted to high-technology start-ups. This is truly sad.

SEC regulation of public SBICs has played a major role in bringing about the end of the majority of the publicly-held SBICs. SBIC shareholders have been "protected" into extinction. We believe that this damaging and unhealthy situation should be corrected by exempting SBICs from the Securities Act of 1940.

Mr. BROYHILL. You heard Mr. Garrett outline some of the provisions that he suggested would be applicable to a venture capital firm if they were exempt from the 1940 act. They included such things as requiring a majority of outside directors, certain prohibitions on inside or self-dealing, and so forth.

I assumed you have heard those. If those had been in existence so that your firm could have taken advantage of them, would you still be in existence today, do you think?

Mr. CHAMBERS. We might well be, but I think it is very important that the principals in a venture capital company are not asking somebody else to do with their money what they are not willing to do with their own money, and that is why in our firm the directors have always owned from a quarter to a third of the company, and I do not think that should be prevented.

I think that is vital and should be encouraged.

Mr. BROYHILL. Certainly. I think that the restriction that he was talking about was an insider owning part of the firm that you are investing in.

Mr. CHAMBERS. We have lived with it and we can live with it and I think that would be a reasonable thing to do.

Mr. BROYHILL. Mr. Opper, do you have any questions?

Mr. OPPER. Just to clarify your testimony, Mr. Chambers, the reason for your liquidation was not solely the SEC regulations although I think we all understand some of the burdens that it imposes.

Mr. CHAMBERS. I made the point in the testimony it was for taxation and the regulation; it was the dual reason.

Mr. OPPER. You have a statement in the first page of your testimony, that half of your shareholders voted overwhelmingly to terminate operations. The market value of your shares then immediately doubled. You conclude that this can only mean that the cost of double taxation at the corporate level and the onerous burden of SEC regulations was nearly 50 percent of the company's net worth, and: "Is this not astonishing evidence?" Do you feel that SEC regulations translated into that kind of a market value?

Mr. CHAMBERS. It certainly happened to us. What could one conclude other than that this was the kind of price put on it? We are classed as a mutual fund, which we are not, and as soon as we take this action we are no longer a mutual fund. Therefore, we are worth considerably more.

Mr. OPPER. Well, at the time that you liquidated you were selling at less than book value, is that not right? In looking at the notice of the special meeting dated August 31 it indicates that the over-the-counter price was about $12.50 and the net asset value per share was about $16.24. On top of that there was a tax benefit of a little more than $3 per share as a result of dissolution which would raise presumably, the net asset value somewhere beyond $19. Thus, even without the burden of SEC regulations your liquidating value is substantially more than 50 percent above your over-the-counter price.

Am I misinterpreting that? Are you really saying that you are worth more liquidating than you are operating?

Mr. CHAMBERS. That is true.

Mr. OPPER. And that operating as an investment company the market will never give you sufficient recognition of your worth, is that right? Does this have anything to do with the double taxation feature which you encountered?

Mr. CHAMBERS. If you sell an investee for cash in our form of organization, it is taxable income. If you have a public market, if your Federal Express becomes a public company and you distribute the shares, then you do not pay the stock; but in this year we will take four significant profits. One now in registration is effective, but all of those are for cash.

Mr. OPPER. To go back to the question that Mr. Broyhill asked you, would you consider a public sale of your securities, now, if you felt the 1940 act would not apply or would you continue to remain a relatively privately held company?

Mr. CHAMBERS. You have to solve both the taxation, the duplicate taxation and the 1940 act problem to make it appealing to anyone to have a public company. Although the partnership form is certainly doable, it has obvious disadvantages.

What this country needs is a form of organization which is designed for venture capital, which is specific for that purpose.

Mr. OPPER. What you are saying with respect to SBIC's is that if the exemption from the 1940 act is not in tandem with some kind of amendment to the tax laws, it might not be utilized by SBIC's?

Mr. CHAMBERS. You are now dealing with only 15 effective SBIC's. That is not very many in a country the size of ours. You also have seen no new SBIC's develop public markets.

Mr. OPPER. Will we if we don't have the tax remedy as well?

Mr. CHAMBERS. I would doubt it.

Mr. OPPER. This is a two-step process?

Mr. CHAMBERS. This is a two-step process.

Mr. OPPER. The 1940 act, as well as amendments to the Internal Revenue Code.

Mr. CHAMBERS. And there is legislation in progress for that, I have been told.

Mr. OPPER. Thank you very much.

Mr. BROYHILL. Thank you very much for coming across the country, Mr. Chambers, to give us this story.

The subcommittee will stand in adjournment.

[Whereupon, at 1:31 p.m., the subcommittee was adjourned.]

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