THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 20, 1992

The Honorable J. Danforth Quayle
President of the Senate
S-212 Capitol Building
Washington, D.C. 20515

Dear Mr. President:

On behalf of the Securities and Exchange Commission, I am pleased to submit for consideration by Congress a legislative proposal entitled the "Small Business Incentive Act of 1992," which is enclosed.

The availability of capital is particularly critical for millions of small American businesses as they seek to develop new products, expand their facilities and add employees. In recent years, the financing available to small businesses from traditional sources like banks and venture capital firms appears to have fallen short of the needs of small businesses. At the same time, many costs for small businesses, particularly those caused by regulation, have grown. The combination of these trends has resulted in less vitality in the small business sector, which is the traditional backbone of the U.S. economy.

The proposed legislation would allow the Commission to increase the size of the small offerings that could be exempt from registration under Section 3(b) of the Securities Act of 1933 from $5 million to $10 million. This change would permit the Commission to facilitate capital-raising by small businesses in a manner consistent with the protection of investors. The Commission has exercised its current authority under Section 3(b) to permit small public offerings under the Commission's Regulation A to be made without registration and without the automatic imposition of the continuous reporting obligation under the Securities Exchange Act of 1934. At the same time, Regulation A assures that investors receive a simplified offering circular that has been reviewed by the SEC. The Commission has recently proposed for public comment an increase in the annual permissible amount of offerings under Regulation A to the full $5 million authorized by current law. Any further flexibility to encourage simplified offerings of securities by small businesses will require a change in law as included in our proposed legislation.

The legislation would also make changes to the Investment Company Act of 1940 in a manner designed to make it easier to form pools of investment capital that could be available to fund small business development. The Commission believes that these proposed changes would help create or expand sources of small business financing without creating the type of risks to public investors that the Investment Company Act was originally designed to address.

Finally, the legislation would amend some of the provisions of the Investment Company Act for Business Development Companies ("BDCs"). BDCs are a special type of public investment company investing in, and often providing managerial assistance to, small businesses. The proposed legislation should encourage more public investment in BDCs and more investment by BDCs in small businesses. It would not, however, remove or alter the basic Securities Act and Investment Company Act measures for the protection of investors in BDCs.

The Commission believes this legislative proposal would make a significant contribution to the simplification of the securities laws applicable to small businesses without endangering the protection of investors. By expanding the availability of capital for small businesses and reducing the costs of securities offerings by small firms, the Small Business Incentive Act would encourage growth in the small business sector that has traditionally provided the majority of new jobs and the core of U.S. economic vitality.

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the submission of this legislative proposal.

Thank you for your consideration.

Sincerely,

Richard C. Breeden

Richard C. Breeden
Chairman

Enclosure

cc: The Honorable Thomas S. Foley
The Honorable Donald W. Riegle
The Honorable Jake Garn
The Honorable Christopher J. Dodd
The Honorable Phil Gramm

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF THE SMALL BUSINESS INCENTIVE ACT OF 1992

I. INTRODUCTION

The Commission seeks enactment of the attached legislation, which would amend the Securities Act of 1933 and the Investment Company Act of 1940 to promote capital formation for small businesses and others by removing regulatory constraints that are unnecessary for investor protection. The proposed legislation would increase the statutory limitation for exempted offerings under the Securities Act, and would amend the Investment Company Act with respect to four types of excepted or exempt investment companies that play a critical role in capital formation for small businesses. The legislation also would lessen certain restrictions on the formation and operation of business development companies under the Investment Company Act. These proposals are in furtherance of the directive in the Omnibus Small Business Capital Formation Act of 1980 for the Commission to reduce regulatory burdens on small businesses.

Section 101 of the legislation would increase the offering limitation for exempted offerings under section 3(b) of the Securities Act to $10 million. The proposal would enhance the Commission's efforts to reduce regulatory burdens on small businesses, consistent with the protection of investors.

Section 201 of the legislation would create a new "qualified purchaser" exception from regulation under the Investment Company Act for investment pools whose securities are held by certain highly sophisticated investors. Section 202 of the bill would give the Commission the authority to define by rule those investors that would be eligible to participate in the new "qualified purchaser" pools. The new exception is intended as an alternative to the existing, more narrow exception under section 3(c)(1) of the Investment Company Act, which currently exempts venture capital funds and other pooled investment vehicles whose operations and activities are essentially of a private nature and thus do not warrant federal regulation.

Section 203 would amend section 3(c)(1) itself to facilitate participation in "private" investment companies by corporate investors and registered investment companies. Section 204 would modify section 3(a)(3) to prevent companies from avoiding regulation under the Act by creating subsidiaries that meet the requirements of amended section 3(c)(1).

Section 205 would amend section 6(a) of the Investment Company Act by adding a new section 6(a)(5) to create an exemption for certain qualified business and industrial development companies.

Section 206 would amend section 6(d)(1) of the Investment Company Act. Section 6(d)(1) currently provides that the Commission may exempt certain intrastate closed-end investment companies from any or all of the provisions of the Act. The section today limits such exemptions to companies that do not receive more than $100,000 from the sale of all of their outstanding securities and sell their securities solely through intrastate offerings. The amendment would increase the maximum proceeds that a company may receive from the sale of all of its outstanding securities to $10 million or such other amount as the Commission may determine by rule, regulation, or order.

Section 207 would amend section 2(a)(46) of the Investment Company Act to define a new class of eligible portfolio company to include any company which does not have total assets in excess of $4 million and capital and surplus (shareholders equity less retained earnings) in excess of $2 million. Section 207 would also authorize the Commission to adjust these amounts through rule or order to account for changes in one or more generally accepted indices or other indicators for small business.

Section 208 would amend section 2(a)(48) of the Investment Company Act to provide that a business development company is not required to make available significant managerial assistance to any company which falls within the new definition of eligible portfolio company in section 2(a)(46)(C)(iii), or any company that meets such other criteria as the Commission may by rule or order establish as consistent with investor protection.

Section 209 would amend section 55 of the Investment Company Act to bring securities of companies that fall within the new definition of eligible portfolio company in section 2(a)(46)(C)(iii) within the list of permissible investments. Section 209 also would amend section 55(a)(1)(A) of the Investment Company Act to permit a business development company to acquire the securities of an eligible portfolio company from persons other than the eligible portfolio company or its affiliated persons subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 210 would amend Section 61(a)(2) of the Investment Company Act of 1940 to permit a business development company to issue, without restriction, more than one class of debt securities. Section 210 also would amend section 61(a)(3)(A) to permit a business development company to issue warrants, options, or rights to subscribe or convert to voting securities, under certain conditions, either alone or accompanied by debt or other securities.

II. THE COMMISSION'S PROPOSED LEGISLATION

A. Title I -- Amendment to the Securities Act of 1933

Section 3(b) of the Securities Act authorizes the Commission to exempt certain classes of securities from the registration requirements of that Act if their total offering price to the public does not exceed $5 million. As originally enacted in 1933, section 3(b) contained a $100,000 offering limit. According to its legislative history, the purpose of section 3(b) is to expedite the raising of capital for the commencement or expansion of small business enterprises.[1]

Section 3(b) has been amended on four occasions since its original enactment in order to raise the offering limitation from $100,000 to its current level of $5 million. In 1945, from $100,000 to $300,000; in 1970 from $300,000 to $500,000; in May, 1978 from $500,000 to $1.5 million; in October, 1978 from $1.5 million to $2 million; and in 1980 from $2 million to $5 million.[2] The principal purpose of these amendments was to compensate for increases in costs to small businesses. The increases were also made to encourage underwriters to participate in offerings by small business issuers. As

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[1] *See, e.g.*, 59 Stat. 167 (May 15, 1945); 84 Stat. 1480 (Dec. 19, 1970); Pub. L. No. 95-283 (May 21, 1978); 92 Stat. 962 (Oct. 6, 1978); and Pub. L. No. 96-477 (Oct. 21, 1980).

[2] *Id.*

underwriters typically charge a percentage of the total offering amount, a small offering may not be as attractive to underwriters as a large offering. Increases in the offering limitations were therefore intended to make exempt offerings more attractive to underwriters and to enhance small issuer access to underwriters.

The foregoing reasons, which justified prior amendments to the section 3(b) offering limitation, also serve as the basis for the proposal to increase the limit to $10 million. As the Commission has recently proposed to extend its rules to the section 3(b) statutory limit, an increase in the statutory ceiling to $10 million would provide the Commission with flexibility in the future and free the Committee of the need to legislate on a frequent basis in the future. Within the proposed limit, the Commission could increase the offering limitation for small business issuers as well as business development companies, which invest in small businesses.

B. Title II -- Amendments to the Investment Company Act of 1940

1. Legislation Creating a New "Qualified Purchaser" Exception from Regulation under the Investment Company Act

Section 3(c)(1) of the Investment Company Act generally excepts from the definition of investment company any issuer that does not have more than 100 investors and does not engage or propose to engage in a public offering. Currently, a wide variety of investment pools rely on the section 3(c)(1) exception. These pools range from small groups of investors acting as "investment clubs" to innovative investment vehicles well-suited for sophisticated investors. Venture capital funds are section 3(c)(1) issuers that are particularly critical in providing capital to smaller businesses. Too often, however, large-scale capital participation by sophisticated investors in venture capital funds and other private investment companies is frustrated by the requirements of section 3(c)(1).

To eliminate unnecessary constraints, a new "qualified purchaser" exception is warranted for investors who are able to accept the risks typically associated with investing in smaller enterprises about which little information is publicly available. The new provision would except any company all of whose security holders meet objective standards of financial sophistication. There would be no prohibition on public offerings nor a limit on the number of investors. As an alternative to the more narrow exception provided under section 3(c)(1), the proposed qualified purchaser exception is intended to encourage participation in venture capital funds and other vehicles by investors who do not need the protection of the Investment Company Act's regulatory structure, thereby increasing the capital available for small business as well as larger concerns.

The legislation would create a new section 3(c)(7) of the Investment Company Act to read as follows:

> (7) Any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers. Such issuer nonetheless is deemed to be an investment company for purposes of the limitations set forth in section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company, and the sale of any security issued by any registered open-end investment company to any such issuer.

In addition, to implement the new exception, the legislation would amend section 2(a) of the Act by adding the following new subparagraph (51):

> (51) "Qualified purchaser" means any person whom the Commission, by rule or regulation, shall have determined not to need the protections of this title on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with an issuer, or such other factors as the Commission may determine to be within the intent of the definition.

Proposed section 3(c)(7) would except from regulation under the Investment Company Act any issuer whose securities are beneficially owned exclusively by one or more persons who, at the time of acquisition, are "qualified purchasers." The new exception is premised on the theory that "qualified purchasers" do not need the Act's protections because they are capable of monitoring such matters as management fees, transactions with affiliates, governance, investment risk, and leverage.[3] In addition, the new exception would enable issuers to realize the benefits associated with public offerings, including greater access to capital markets and increased liquidity for their securities.[4]

Proposed section 2(a)(51) would authorize the Commission to define by rule those investors that constitute "qualified purchasers." This rulemaking authority would provide flexibility to respond to changing conditions and the benefit of the public comment process. The Commission's determinations would be based on factors such as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with the issuer, or such other factors as the Commission determines to be within the intent of the section.[5]

The Commission anticipates that, at least initially, the definition of "qualified institutional buyer" in rule 144A under the Securities Act of 1933[6] would represent an appropriate standard for determining the level of sophistication for those institutions investing in proposed section 3(c)(7) issuers. Under rule 144A, a qualified institutional buyer generally includes institutional investors, such as employee benefit plans, insurance companies, banks, and investment companies, that own or invest on a discretionary basis at least $100 million in securities. In addition, the Commission believes that it would be

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[3]The rationale of section 3(c)(7) is not novel. A number of provisions under the federal securities laws are based, in part, on objective criteria concerning the degree of sophistication of investors. *See* section 4(6) of the Securities Act of 1933 (*accredited investors*), rule 144A under that Act (17 C.F.R. § 230.144A (1991)) (*qualified institutional buyers*), and rule 205-3 under the Advisers Act of 1940 (17 C.F.R. § 230.205-3 (1991)) (*"sophisticated" clients*).

[4]Issuers relying on proposed section 3(c)(7) would be permitted to engage in public offerings registered under the Securities Act of 1933, so long as their securities are owned only by qualified purchasers.

[5]In defining eligible investors, the Commission could also decide to provide reasonable care defenses similar to those in Regulation D and rule 144A. 17 C.F.R. §§ 230.501(a) & 230.144A (1991).

[6]Rule 144A provides a non-exclusive safe harbor for resales of unregistered securities. *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6862 (Apr. 27, 1990).

appropriate to allow natural persons to invest in the new section 3(c)(7) pools, so long as those persons possess a high degree of sophistication. As in the case of their institutional counterparts, such natural persons would be fully capable of evaluating and accepting the level of risk associated with the new section 3(c)(7) pools. In formulating the class of investors eligible to invest in proposed section 3(c)(7) issuers, the Commission would be particularly sensitive to the risks presented by unregulated investment pools and the breadth of the proposed section 3(c)(7) exception, which would not otherwise be limited.

The new exception would not limit investments by registered investment companies in section 3(c)(7) issuers as is currently the case for certain excepted issuers relying on section 3(c)(1). Investments in registered investment companies by section 3(c)(7) issuers, however, would be restricted under section 12(d)(1) of the Investment Company Act[7] for the same reasons supporting this approach for all section 3(c)(1) issuers as discussed below. Finally, an issuer qualifying for the new section 3(c)(7) exclusion nonetheless could register under the Investment Company Act if it chose to forego the exclusion.

2. Legislation Amending Sections 3(c)(1) and 3(a)(3) of the Act

Section 3(c)(1) of the Investment Company Act represents a viable and important exception for private investment pools. Certain aspects of section 3(c)(1), however, should be improved.

To qualify for the section 3(c)(1) exception, an issuer generally may not have more than 100 investors and may not engage in a public offering. These two requirements are intended to provide a means for determining the existence of a public investment company for which regulation under the Act is clearly justified.

Section 3(c)(1) also has a two-part attribution text, designed to prevent circumvention of the 100 investor limit. This test, which may require a prospective section 3(c)(1) issuer to "look through" its security holders to their underlying investors, is best illustrated by an example. Assume Company B is seeking to rely on section 3(c)(1). If Company A beneficially owns ten percent or more of Company B's voting securities, Company A's security holders are counted individually as security holders of Company B (*part I of the attribution provision*), unless Company A has no more than ten percent of its assets in securities of section 3(c)(1) issuers (*part II*).

The attribution test is also pivotal in determining which section 3(c)(1) issuers are deemed to be investment companies for purposes of the "fund of fund" investment limitations of section 12(d)(1) of the Act. Section 12(d)(1) is intended to restrict the pyramiding of funds by limiting the purchase of registered investment company securities by any investment company (whether or not registered) and the purchase of securities of any investment company (whether or not registered) by registered funds.[8] Unlimited pyramiding raises public policy concerns because, for example, a fund acquiring another fund's

[7] *See infra* note 7.

[8] Section 12(d)(1) prohibits such purchases if, after the purchase, the acquiring company owns (1) more than three percent of the voting stock of the acquired company; (2) securities issued by the acquired company having an aggregate value of more than five percent of the assets of the acquiring company; or (3) securities issued by the acquired company and all other investment companies having an aggregate value of more than ten percent of its assets.

securities could exercise undue influence over that fund or disrupt its orderly management through the threat of redemption. Such investments may also result in a layering of costs to investors through duplicate advisory fees, administrative expenses, and sales charges.

Under current section 3(c)(1), only those issuers that would be investment companies but for the second part of that section's attribution provision (*i.e.*, they have large security holders but these holders do not have more than ten percent of their assets in securities of section 3(c)(1) issuers) are subject to section 12(d)(1)'s restrictions on inter-fund investments. Pyramiding investments involving other section 3(c)(1) issuers and investment companies are not subject to section 12(d)(1).

The Commission believes that the current attribution test of section 3(c)(1) is unnecessarily broad. Investments in section 3(c)(1) issuers by companies that are not themselves investment companies generally do not, standing alone, raise the concerns respecting the layering of intermediaries that the attribution test is intended to address. In fact, the attribution provision may result in the counting of the security holders of corporate investors who do not have a significant economic interest in a section 3(c)(1) issuer's performance.

The proposed legislation would simplify the attribution test of section 3(c)(1). Under the proposal, if an intermediate investing entity (*i.e.*, Company A) is not an investment company subject to regulation under the Act, or is itself not relying on section 3(c)(1) or the proposed qualified purchaser exception, the issuer (*i.e.*, Company B) would not be required to consider the entity's security holders in applying the 100 investor limit.

In connection with this change, the legislation would also amend section 3(a)(3) of the Act to provide that securities of majority-owned subsidiaries that would be investment companies but for amended section 3(c)(1) would not be excluded from the definition of "investment securities" under section 3(a)(3). This amendment is intended to preclude a company that would itself fall within the definition of an investment company under section 3(a)(3) from avoiding regulation under the Act by establishing a section 3(c)(1) subsidiary.[9]

The Commission also believes that the investment restrictions of section 12(d)(1) as applied under current section 3(c)(1) should be revised. Limitations on the ability of *all* section 3(c)(1) issuers to invest in registered investment companies are necessary to protect the public shareholders of registered funds. Section 3(c)(1) issuers, excepted from regulation under the Act, could acquire controlling interests and exert undue influence over registered investment companies, disrupting their portfolio management through the threat of redemption.

As applied to investments by registered investment companies, on the other hand, section 12(d)(1) unduly restricts the ability of a registered fund to invest in a section 3(c)(1)

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[9]Section 3(a)(3) generally provides that an investment company includes any company with more than 40% of its assets in investment securities. The definition of investment securities under section 3(a)(3) excludes securities issued by majority-owned subsidiaries which are not investment companies; because of the section 3(c)(1) exclusion, the securities of a majority-owned section 3(c)(1) issuer are not investment securities. In light of the proposed change in the attribution provision of section 3(c)(1) and in the absence of the proposed amendment to section 3(a)(3), companies could avoid regulation under the Act by "downstreaming" their investment activities through a section 3(c)(1) subsidiary.

issuer.[10] The Commission believes any anti-pyramiding concerns are minimized by the other safeguards under the Act governing such investments, such as the Act's provisions regarding conflicts of interest and breaches of an adviser's fiduciary duty. Moreover, as a result of the proposed legislation as noted below, a registered fund's investment would be limited to ten percent of any one section 3(c)(1) issuer.

Accordingly, the proposed legislation would revise the "fund of fund" investment restrictions of section 12(d)(1) as applied to private investment companies. As revised, section 12(d)(1) would apply to any private investment company's purchase of the voting securities of a registered investment company, whether open-end or closed-end;[11] it would no longer apply to a registered fund's purchase of private investment company securities. The combined effect of the proposed changes to the application of section 12(d)(1) and the attribution provision would be to raise the limit on investment company purchases of section 3(c)(1) issuers from three percent to ten percent of any one such issuer.[12] Based on the general size of portfolio positions taken by small capitalization and aggressive growth funds and of private investment companies, the Commission believes that this increase is sufficient to accommodate registered investment companies seeking to invest in section 3(c)(1) issuers.

3. Legislation to Create a New Exemption from Regulation under the Investment Company Act for Qualified Business and Industrial Development Companies that are Organized to Provide Assistance to Businesses and Whose Operations are Subject to State Regulation

Business and industrial development companies (or "BIDCOs") are organized for the express purpose of providing financing, and in some cases managerial assistance, to projects or concerns located within a particular state. Such companies typically are licensed by a state and regulated under state law.[13] Because of their extensive investments in securities, these companies frequently fall within the definition of an investment company under section 3(a) of the Investment Companies Act. Therefore, unless an exemption or an exception is available, they are subject to stringent regulation at both the state and federal level.

While substantive regulation at both the state and federal level may increase investor protection, it also increases the operational costs of these companies. These additional costs

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[10]Section 12(d)(1) limits investments by registered funds to no more than three percent of certain section 3(c)(1) issuers. *See* note 7 and accompanying text.

[11]To cover the other side of transactions involving open-end funds, section 12(d)(1) also would apply to a registered open-end investment company's sale of its securities to a section 3(c)(1) issuer. The application of section 12(d)(1) to all section 3(c)(1) issuers under the proposed amendments would not affect existing investments by such issuers in registered funds since section 12(d)(1) prohibits only purchases or other acquisitions that cause holdings to exceed the numerical limits in the section.

[12]The revised attribution provision of section 3(c)(1) would count toward the 100 investor limit, without exception, the shareholders of an investment company owning 10% or more of a section 3(c)(1) issuer.

[13]Currently, 45 states have enacted laws regulating such companies. *See, e.g.*, Cal. Fin. Code §§ 31000-31953 (Deering 1991) (Business and Industrial Development Corporations Law); Tenn. Code Ann. §§ 45-8-201 to -225) (1991) (Tennessee BIDCO Act); Wash. Rev. Code Ann. §§ 31.24.010. to -900. (1990) (Washington Industrial Development Corporations).

have a significant adverse effect even on companies able to coordinate large, interstate offerings. BIDCOs designed to stimulate local economies typically operate on a smaller scale. For these companies, the cost of dual regulation can exhaust a significant percentage of their capital and human resources.

The Commission has granted a number of individual exemptive orders from the provisions of the Investment Company Act with regard to some BIDCOs.[14] The time and money involved in applying for such exemptions, however, may discourage would-be sponsors of small BIDCOs. An exemption from regulation under the Act for BIDCOs would eliminate unnecessary federal obstacles to the organization and operation of these vehicles.

Section 204 of the bill would amend section 6(a) of the Act by adding subparagraph (5) as follows:

> (5)(A) Any company that is not engaged in the business of issuing redeemable securities, the operations of which are subject to regulation by the State in which it is organized under a statute governing entities that provide financial and/or managerial assistance to enterprises doing business, or proposing to do business, primarily in that State, provided that
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> > (i) the organizational documents of such company state that the purpose of the company is limited to providing financial and/or managerial assistance to enterprises doing business, or proposing to do business, primarily in that State;
> >
> > (ii) immediately following each sale of the securities of such company by the company or any underwriter therefor, not less than 80 per centum of the company's securities being offered in such sale, calculated on a class-by-class basis, are held by persons who reside, or have a substantial business presence, in that State;
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> > (iii) the securities of such company are sold, or proposed to be sold, by the company or any underwriter therefor, solely to accredited investors, as defined in section 2(15) of the Securities Act of 1933, or to such other persons that the Commission, as necessary or appropriate in the public interest and consistent with the protection of investors, may permit by rule, regulation, or order; and
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> > (iv) the company does not purchase any security issued by an investment company, as defined in section 3 of this title, or by any company which

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[14] *See, e.g.*, Indiana Community Business Credit Corporation, Investment Company Act Release Nos. 14528 (May 21, 1985) (Notice) and 14585 (June 18, 1985) (Order); Business and Industrial Development Corporation of Washington, Investment Company Act Release Nos. 7250 (June 28, 1972) (Notice) and 7301 (Jul. 28, 1972) (Order); and Pennsylvania Development Credit Corporation, Investment Company Act Release Nos. 3954 (Apr. 6, 1964) (Notice) and 3965 (Apr. 28, 1964) (Order). Orders issued to BIDCOs have been subject to various conditions, including requirements that the companies be subject to state licensing and regulation and that potential investors be sophisticated in securities matters and capable of understanding the risks involved.

would be an investment company except for the exclusion from the definition of investment company in section 3(c) of this title, other than

(aa) any security that is rated investment grade by at least one nationally recognized statistical rating organization; or

(bb) any security issued by a registered open-end investment company that is required by its investment policies to invest at least 65 per centum of its total assets in securities described in subsection (aa) above or that are determined by such registered open-end investment company to be comparable in quality to securities described in subsection (aa) above.

(B) Notwithstanding the exemption provided in this section, the provisions of section 9 (and, to the extent necessary to enforce such provisions, sections 38 through 51) of this title shall apply as if the company were an investment company registered under this title.

(C) Any company proposing to rely on the exemption provided in this section shall file with the Commission a notification stating that it intends to rely on the exemption, in such form and manner as the Commission may by rule prescribe.

(D) Any company meeting the requirements of this section shall be entitled to rely on the exemption provided herein immediately upon filing with the Commission the notification described in subsection (C) above, unless and except insofar as the Commission determines by order that such company's reliance is not in the public interest or consistent with the protection of investors.

(E) The exemption provided pursuant to this section may be subject to such additional terms and conditions as the Commission may by rule, regulation, or order determine are necessary or appropriate in the public interest or for the protection of investors.

The proposed legislation is premised upon states having a strong interest in protecting investors in companies of this type and, accordingly, the new exemption would be available only to those companies in which a state has a strong regulatory interest. The individual states are best situated to examine the needs of their residents and to determine the structure and operations of entities intended to meet the requirements of local business for capital formation, while also protecting state residents from abusive practices in the investment industry.

A company seeking to rely on the proposed exemption would be required to be organized in the state where it is regulated. In addition, proposed section 6(a)(5)(A)(i) would emphasize the intent of the exemption by requiring that the organizational documents (such as the articles of incorporation) of companies relying on the exemption state that the purpose of the company is limited to providing financial and/or managerial assistance to enterprises doing business, or proposing to do business, primarily in the state under which laws the company is regulated.

Proposed section 6(a)(5)(A)(ii) provides that immediately following each sale of the company's securities by the company or any underwriter therefor, not less than eighty percent of the company's securities being offered in such sale, calculated on a class-by-class basis, must be held by persons who reside, or who have a substantial business presence, in the state where the company is regulated. The eighty per cent requirement provides flexibility for companies located near state borders while insuring the states will have a strong interest in regulating the companies' operations. While the residency requirement would apply to each new offering, it would not apply with respect to transactions made on the secondary market. The Commission anticipates that the percentage of securities owned by persons residing or with a substantial business presence in the state where the company is regulated will vary from time to time due to resales of the securities, changes in residency of the holders of the securities, and transfers of the securities through operation of law.

Proposed section 6(a)(5)(A)(iii) would limit the exemption to those companies that offer their securities solely to accredited investors, as defined in section 2(15) of the Securities Act of 1933, and Commission rules thereunder, or to such other persons as the Commission may permit. The section would not, however, preclude the sale of securities through a public offering.

The Commission believes that the proposed eligibility standard for section 6(a)(5) should be different from that applicable to the proposed exemption for qualified purchasers as defined in proposed section 2(a)(51). The qualified purchaser exception focuses solely on the nature of the purchaser. In contrast, proposed section 6(a)(5) is limited to a specific type of issuer and relies on state law to provide alternative regulatory protections. Companies relying on section 6(a)(5) are likely to be smaller in scale and more local in operation than most entities relying on the qualified purchaser exception.

Proposed section 6(a)(5)(A)(iv) would prohibit exempt companies from purchasing securities issued by investment companies, other than securities rated investment grade by at least one nationally recognized statistical rating organization or securities issued by registered open-end investment companies that invest at least sixty-five percent of their assets in such securities or similar obligations. The Commission expects that exempt companies would make long-term investments solely in companies that are primarily engaged in businesses other than investing, reinvesting, owning, holding, or trading in securities. Thus, except as noted above, an exempt company could not invest in any issuer that, but for an exclusion in section 3(c) of the Investment Company Act, would meet the definition of investment company. To provide exempt companies with the flexibility to invest capital not immediately needed for investment in operating companies, the proposal would permit the purchase of investment grade securities regardless of whether the issuer is an investment company, and also would permit the purchase of securities issued by registered open-end investment companies that invest primarily in investment grade securities or comparable securities.

Proposed section 6(a)(5)(B) provides that the provisions of section 9 of the Investment Company Act would apply with respect to the exempt company as if it were a registered investment company. Section 9 of the Act provides that certain activities disqualify a person, and concomitantly, certain related persons, from acting in specified capacities on behalf of investment companies. Section 9 is based on the determination that certain persons, because of securities-related violations, should be disqualified from any involvement with registered investment companies absent an order of the Commission allowing such involvement. Section 6(a)(5)(B) would ensure that the proposed exemption for BIDCOs does not provide a safe haven for persons prohibited from associating with investment companies. Certain administrative sections of the Act also would apply to ensure that the Commission has enforcement power over any violations of the section.

Proposed section 6(a)(5)(C) requires companies to file with the Commission a notification of the company's intent to rely on the exemption. The Commission intends to promulgate rules setting forth the minimum information that must be included in the notification. It is anticipated that the notification would include at least the following information: the company's name, address, and telephone number; and a list of the company's officers and directors.

Pursuant to proposed section 6(a)(5)(D), although the exemption would become automatically available upon filing the required notification, the Commission may institute proceedings to determine whether a company's reliance on the exemption is not in the public interest or consistent with the protection of investors. This authority would allow the Commission to deny the exemption in circumstances where, for example, the Commission is in possession of information relating to the *bona fides* of the entity or its sponsors.

Proposed section 6(a)(5)(E) provides that the exemption may be subject to such additional terms and conditions as the Commission may by rule, regulation, or order determine necessary for the protection of investors. This authority would allow the Commission, for example, to require BIDCOs selling securities outside the state in which they are organized to provide certain information to regulators in those other states.

4. Legislation to Amend Section 6(d)(1) of the Investment Company Act to Increase the Aggregate Proceeds Raised by Closed-End Funds Engaged in Intrastate Offerings

Section 6(d) of the Investment Company Act currently provides that the Commission shall exempt a closed-end investment company from any or all of the provisions of the Act, subject to such terms and conditions as may be necessary or appropriate in the public interest or for the protection of investors, provided that the aggregate amount of proceeds permitted to be received from offerings of the company's securities is not more than $100,000, and provided further that the public sale of the company's securities by the company or any underwriter therefor is made solely through intrastate offerings. In contrast to proposed section 6(a)(5), an exemption under section 6(d) is not automatic in that a company must apply for an exemption from all or some of the provisions of the Act.[15]

The $100,000 maximum aggregate amount of proceeds specified in section 6(d)(1) has remained unchanged since 1940. This amount should be increased to reflect more accurately current financial requirements of companies providing capital to small businesses and others. In addition, in order to respond to changing financial conditions, the Commission should have the authority to adjust the ceiling by rule or order.

Section 206 of the bill would amend section 6(d)(1) of the Investment Company Act to increase the aggregate amount of proceeds that may be raised in intrastate offerings by closed-end funds to $10 million or such other amount as the Commission may set by rule or order.

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[15]Section 6(d) and proposed section 6(a)(5) would represent alternative exemptions from a substantive perspective as well. If a state does not have a regulatory structure in place for business and industrial development companies, or if such a company cannot otherwise meet the requirements of proposed section 6(a)(5), the Commission may exempt under section 6(d) a proposed intrastate offering from all or part of the Investment Company Act if it determines, after examining the specific proposal, that the exemption is consistent with the protection of investors.

Under the proposed legislation, the Commission would continue to review individual applications to determine whether an exemption is consistent with the protection of investors, despite the absence of specific state regulation. Where appropriate, the Commission would continue to grant the requested exemption under section 6(d), subject to compliance with specified provisions of the Act, and such other terms and conditions as are necessary or appropriate in the public interest or for the protection of investors.

5. <u>Legislation Amending Section 2(a)(46) of the Investment Company Act</u>

Section 2(a)(46) of the Investment Company Act defines eligible portfolio company to include companies that are not eligible for margin under Federal Reserve Board regulations, are controlled by a business development company, or that meet such other criteria as the Commission may establish by rule. The Commission believes that this definition may be difficult to apply and may impede investments in some small businesses. The proposed legislation would amend section 2(a)(46) of the Investment Company Act to define a new class of eligible portfolio company. It would expand the definition of eligible portfolio company to include any company which does not have total assets in excess of $4 million and capital and surplus (shareholders equity less retained earnings) in excess of $2 million. It would also authorize the Commission to adjust these amounts through rule or order to account for changes in one or more generally accepted indices or other indicators for small business. The Commission believes that this amendment will provide a bright-line test for small businesses and should result in business development companies investing more assets in small businesses.

6. <u>Legislation Amending Section 2(a)(48) of the Investment Company Act</u>

Section 2(a)(48) of the Investment Company Act requires a business development company to make available significant managerial assistance to all the companies treated by it as satisfying the 70% test in Section 55 of the Act. The Commission believes that this requirement may discourage the flow of capital to very small businesses. The proposed legislation would amend section 2(a)(48) of the Investment Company Act to provide that a business development company is not required to make available significant managerial assistance to any company which falls within the new definition of eligible portfolio company in section 2(a)(46)(C)(iii), or any company that meets such other criteria as the Commission may by rule or order establish consistent with investor protection.

7. <u>Legislation Amending Section 55 of the Investment Company Act</u>

Section 55 of the Investment Company Act prohibits a business development company from making investments unless, at the time an investment is made, at least 70% of its assets (excluding assets necessary to maintain the business, such as office furniture) are represented by, in general, securities of small, developing or financially troubled businesses and liquid assets such as cash, government securities, or short-term high quality debt securities. The Commission believes that securities of very small businesses should specifically be included within the 70% test in section 55. The proposed legislation would, therefore, amend section 55 of the Investment Company Act to bring securities of companies that fall within the new definition of eligible portfolio company in section 2(a)(46)(C)(iii) within the 70% test.

Section 55 of the Investment Company Act also requires a business development company to acquire the securities of an eligible portfolio company directly from the portfolio company, or from a person who is, or who within the preceding thirteen months has been, an affiliated person of such eligible portfolio company. The Commission believes that this requirement is too restrictive, since acquisitions of eligible portfolio company securities from other persons may also benefit the company. The proposed legislation would amend section 55(a)(1)(A) of the Investment Company Act to permit a business development company to acquire the securities of an eligible portfolio company from persons other than the eligible portfolio company or its affiliated persons subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

8. Legislation Amending Sections 61(a)(2) and Section 61(a)(3) of the Act

Section 61(a)(2) of the Investment Company Act provides that notwithstanding section 18(c) of the Act,[16] a business development company may issue more than one class of senior debt security if such company does not have any publicly held indebtedness outstanding, there is no intent to publicly distribute any class of debt securities, and all such senior securities are privately held or guaranteed by the Small Business Administration, banks, insurance companies, or other institutional investors. The Commission believes that section 61(a)(2) is too restrictive. Although public investors are not permitted to participate in multiple debt offerings, their equity holdings are affected by the outstanding debt. The proposed legislation would amend section 61(a)(2) to permit a business development company to issue, without restriction, multiple classes of debt. This would further facilitate the flow of capital to small businesses.

Section 61(a)(3)(A) of the Act provides that notwithstanding section 18(d), a business development company may issue senior securities representing indebtedness accompanied by warrants, options, or rights to subscribe or convert to voting securities of such company under certain conditions. Section 18(d) of the Act makes it unlawful for a registered management investment company to issue warrants or rights to subscribe to or purchase the company's securities unless certain conditions are met, including a requirement that they expire no later than 120 days after their issuance. Business development companies are permitted greater flexibility under section 61(a)(3)(A) to issue warrants with expiration dates of up to ten years, but only if the instrument is accompanied by a debt security. The legislative history of section 61(a)(3)(A) is silent regarding the purpose of this limitation and the Commission believes it is not required for investor protection. The proposed legislation would amend section 61(a)(3)(A) to permit a business development company to issue warrants, options, or rights to subscribe or convert to voting securities of such company either on a stand-alone basis or when accompanied by debt or equity securities.

III. CONCLUSION

By raising the statutory limit for exempted offerings under the Securities Act, the proposed legislation would provide the Commission with additional flexibility to increase the offering limitation for small business issuers as well as business development companies. By removing unnecessary regulatory constraints, the legislation would promote the formation of

[16]Section 18(c) makes it 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 under certain conditions.

capital for small businesses and others through broader-based participation in excepted and exempted investment pools under the Investment Company Act. It also would remove unnecessary restrictions on the formation and operation of business development companies. The proposed legislation would accomplish these objectives without compromising important investor protections. In view of the costs of unnecessary regulation and the importance of capital formation to the growth and health of our economy, these are important and needed amendments.