

MEMORANDUM

25-1-1  
AUG 9 1971

TO: The Commission

FROM: The Division of Corporate Regulation *RJ*

RE: Suggested Safeguards in order to protect investors in Small Business Investment Companies which may issue stock options.

RECOMMENDATION: That the Commission authorize the sending of the attached letter.

Background

By its order of May 14, 1971, the Commission granted an exemption so as to permit the issuance of stock options by registered small business investment companies ("SBIC's") to their officers and employees.<sup>1/</sup> In its Findings and Opinion the Commission noted the restrictions placed on "qualified" options under Section 422 of the Internal Revenue Code and observed that "such further safeguards as may seem necessary for the protection of investors in SBIC's would be provided through regulations to be adopted by the SBA."<sup>2/</sup>

The Commission's order not only conditioned the exemption "to such options as qualify under Section 422 of the Internal Revenue Code as amended" but indicated the need for additional investor safeguards by imposing the additional condition "that such exemption not be effective until notice is given of the adoption by the Small Business Administration

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1/ The National Association of Small Business Investment Companies, Investment Company Act Release No. 6523 (May 14, 1971).

2/ Ibid., p. 8

of regulations satisfactory to this Commission with respect to the issuance of qualified options by Small Business Investment Companies."<sup>3/</sup>

Despite these indications of the Commission's view that the restrictions placed on "qualified" options by Section 422 of the Internal Revenue Code would not afford adequate protection for investors in SBIC's, an official of SBA has suggested that the SBA issue a regulation merely "stating that stock options issued by such SBIC's must be 'qualified' options under Section 422 of the Internal Revenue Code."<sup>4/</sup>

#### Suggested Additional Safeguards

The Division is of the view that in order to provide adequate safeguards for investors in SBIC's, such companies should be permitted to issue qualified stock options only if (1) the option by its terms is exercisable by the individual to whom it is granted only if at all times during the period beginning with the date of the granting of the option and ending 3 months before the date of such exercise, such individual was an officer or employee of the registered SBIC or a wholly-owned subsidiary thereof; (2) not more than an aggregate of 25% of the shares covered by a plan shall be optioned to individuals who at the time the plan is

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<sup>3/</sup> Ibid., p. 13. In its Findings and Opinions the Commission anticipated that the staff of the Commission and the SBA staff would accommodate the Commission's requirements for investor protection. Ibid., p. 8.

<sup>4/</sup> Letter of James Thomas Phelan, Deputy Associate Administrator for Programs Operation, SBA, to Solomon Freedman, dated June 24, 1971.

adopted are officers or employees of the SBIC; (3) in any event, the aggregate exercise price of the shares which may be subject to option by any one individual during the period covered by the plan shall not exceed 150% of the regular annual cash compensation paid to him at the time of the grant of the option (4) no option is granted and no granted option, by its terms, is exercisable unless (i) the registered SBIC does not have an investment adviser (as defined in the Investment Company Act of 1940) at the time the option is granted or exercised, as the case may be, and (ii) the registered investment company did not have an investment adviser at any time during a period of one year preceding the date of the grant or exercise of the option, as the case may be; and (5) during the period beginning with the date of the granting of the option and ending with the last day on which the option is or was exercisable, the exercise price shall not be reduced by modification, by cancellation of old options and issuance of new ones, by adoption of a new plan, or in any other manner.

Staff Comments

We believe that fairness to the investors in SBIC's requires that each of these safeguards be provided. Item (1) merely assures that the grantee of the option will be an officer or employee of the SBIC itself or a wholly-owned subsidiary rather than an officer or employee of a subsidiary or of a parent of the SBIC as permitted by the Internal Revenue Code. As

respects the issuance of stock options by subsidiary companies of an SBIC, it should be noted that Rule 17d-1(d) already authorizes the issuance of stock options to their officers or employees by non-investment companies which are controlled by registered investment companies.

The safeguards afforded by Items (2) and (3) are identical to safeguards imposed by the Commission when it permitted a registered holding company to issue stock options.<sup>5/</sup> Item (2) gives some assurance that a good part of the options will be available to overcome the competitive disadvantage which SBIC's claim they face in attracting new personnel and that only a reasonable amount of options will be available for existing personnel; Item (3) would place a reasonable ceiling on the number of shares optioned to any one individual.

Item (4) would operate to prevent rewarding management with options when the company's performance depends, in fact, upon the abilities of a paid investment adviser, which most likely is comprised of the management itself.

Item (4) would operate to prevent the exercise price, once set, from being scaled down for the exclusive benefit of the grantee. When market prices drop, some managements give themselves another chance by cutting prices on their stock options. This practice has been criticized by such staunch supporters of stock options as Henry Ford II, James Barr, former Chairman of Montgomery Ward & Co. Inc., and Roy G. Jeter, vice-president of B.F. Goodrich Company.<sup>6/</sup> The objection to cutting prices

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<sup>5/</sup> Middle South Utilities, Inc., 40 S.E.C. 509 (1961).

<sup>6/</sup> Stock options: Should Executives Get a Second Chance?, Forbes, May 15, 1963, p. 13.

on options has been variously denounced as "too much of a good thing," "stacking the deck for the executives," and "heads I win tails you lose." One critic puts it this way, "Stockholders take a risk when they invest in a company and have a right to expect executives to take a chance as well."<sup>7/</sup>

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<sup>7/</sup> Ibid., pp. 13-14.

Sweetwood:dsb  
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*N. Swartz*  
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