TESTIMONY OF

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CONCERNING THE SMALL BUSINESS INCENTIVE ACT OF 1993

BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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the Commission's "small business initiative," the Commission has taken several significant steps to enhance the utility of structured finance vehicles for small business capital formation. The measures proposed in the Small Business Loan Securitization and Secondary Market Enhancement Act of 1993 should facilitate further the use of structured finance as a source of capital for small business. The Commission strongly believes that wider use of prudent techniques of securitization is probably the best --and quite possibly the only -- technique for really ending the "credit crunch" that has afflicted small business across the country.

Introduction

The past year has witnessed a great deal of discussion about the flow of capital to small business.[2] This discussion has been prompted by a growing concern that small business, which provides the major source of jobs for the American worker,[3] has been unable to raise or borrow capital with which to fuel growth, innovation, and expansion. "Capital is of course critical to any business, particularly small business. In recent times, however, financing for small business from traditional sources available to a company that is smaller than the size typically able to conduct an initial public offering has become more difficult to obtain."[4]

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2 *See, e.g.*, Udayan Gupta, *Venture Capitalists Raised 75% More Money Last Year*, WALL ST. J., Jan. 29, 1993, at B2, col. 3; Udayan Gupta, *Venture Funds Regain Appetite For Start-Ups*, WALL ST. J., Sept. 21, 1992, at B1, col. 6; Brent Bowers, *Effort Grows to Help Tiny Firms Get Equity Financing*, WALL ST. J., Mar. 16, 1992, at B2, col 3.

3 *See* Figure A.

4 Statement of Commission Chairman Richard C. Breeden, Hearing Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs, 102d Cong., 2d Sess. (Mar. 26, 1992) at 7.

Venture capital firms, which can be either privately or publicly owned companies,[5] are an important source of that capital.[6] From 1982 to 1991, these firms invested over $27 billion in small businesses.[7] New investments by venture capital firms reached a peak of $4.0 billion in 1987.[8] Unfortunately, new investments declined to $1.4 billion in 1991, a ten year low.[9] Preliminary data suggest that these investments may have increased to $2.7 billion in 1992.[10] While a considerable improvement, these investments are substantially below the average of $3.6 billion that prevailed during the second half of the 1980's,[11] and the Commission applauds Congress' determination to press for further action in this area. We recognize and appreciate that the purpose of these bills is to amend the securities laws to enhance investment in small businesses without sacrificing investor protection.

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5 The Commission has no data solely on private venture capital firms, but does have data on two types of public venture capital firms: small business investment companies and business development companies. In 1992, there was a slight increase in the number of small business investment companies: from 10 such companies with $290.5 million in assets in 1991 to 11 such companies with $331.8 million in assets. While there were 49 business development companies in 1992 (one more than in 1991), their assets declined to $2.4 billion from $2.5 billion in 1991. *See* Figure B.

6 We should not overlook that conventional investment companies also are an important source of capital for small businesses. In 1992, there were approximately 148 funds with more than $22.1 billion in net assets that invested primarily in companies with small market capitalizations. In 1991, there were 107 such funds with $16.1 billion in net assets. *See* Figure C.

7 Calculation based on figures in *Disbursements Hit 10-Year Low*, VENTURE CAPITAL J., June 1992, at 27. While there is no uniform definition of "small business," one of the Small Business Administration's definitions includes any company which, together with its affiliates, does "not have net worth in excess of $6 million, and does not have average net income after federal income taxes (excluding any carry-over losses) for the preceding 2 years in excess of $2 million." 13 C.F.R. § 121.802(a)(2), *amended* in 57 FR 62477 (1992).

8 *See Disbursements Hit 10-Year Low*, VENTURE CAPITAL J., June 1992, at 27. *See also* Figure D.

9 *Id.*

10 Figures reflect the first six months of 1992. Analysts with Venture Economics Publishing Co. supplied these figures to the Commission staff.

11 Calculation based on data in *Disbursements Hit 10-year Low*, VENTURE CAPITAL J., June 1992, at 27.

Recent Commission Initiatives in the Area of Small Business.

The Commission has taken several steps this past year to facilitate the flow of capital to small business. Regulations under both the Securities Act of 1933 ("Securities Act")[12] and the Securities Exchange Act of 1934 ("Exchange Act")[13] were amended to remove unnecessary barriers to the registration and sale of securities.

Regulation A under the Securities Act exempts small public offerings from the registration provisions of that Act.[14] Last year, the Commission amended Regulation A to raise the size limit for an offering using this simplified process from $1.5 million to $5 million.[15] Since this change was finalized on July 30, 1992, the volume of Regulation A offerings nearly quadrupled to $89 million, compared with $22.6 million before the Commission's action.[16]

In addition to expanding Regulation A, the Commission dramatically simplified the registration statement previously used for small business offerings, and removed an arbitrary size limit of $7.5 million per offering (or for repeated offerings during the succeeding twelve months following an initial public offering). Since the new "SB-2" form replaced the old S-18 and offering limits were removed in August 1992, 74 offerings covering a total of $641.2 million have been registered with the Commission by small businesses. At the same time, the Commission took action to allow an issuer to use a "test the waters" document to assess interest in its securities before complying with the mandated disclosure requirements.[17] The

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12 15 U.S.C. § 77a.

13 15 U.S.C. § 78a.

14 17 C.F.R. §§ 230.251-263.

15 Small Business Initiatives, Securities Act Release No. 33-6949 (July 30, 1992), 57 FR 36442, 36468 (Aug. 13, 1992).

16 Comparing filings made under Regulation A during the periods of August 13, 1992 through February 19, 1993, and August 13, 1991 through February 19, 1992, respectively.

17 *Id.* at 36476, 36496, 36470.

Commission also amended Rule 504 of Regulation D to allow companies not yet registered under the Exchange Act to offer up to $1 million of unrestricted securities each year through a general solicitation without federal registration or a federal requirement that the offering be registered in the relevant states. Previously, Rule 504 did not permit the general solicitation of investors. Further, unless the securities were registered with the relevant states, they were not freely transferable by the investor, and the issuer was limited to offering $500,000 of unrestricted securities each year. Since the time of our amendments to Rule 504 in August 1992 through the end of calendar year 1992, more than 578 offerings involving $183.1 million have been made, most of which came from small business.[18]

Small Business Registration. The Commission also adopted an integrated registration and reporting system under the Securities Act and the Exchange Act for use by "small business issuers."[19] For purposes of this system, small business issuers generally include those issuers with annual revenues of less than $25 million and whose public float (the market value of voting securities held by non-affiliates) does not exceed $25 million.[20] This integrated system includes a new simplified form for small business issuers to register their securities under the Securities Act (Form SB-2) and allows them to satisfy their periodic reporting requirements under the Exchange Act on new simplified forms designed expressly for small businesses (Forms 10-KSB and 10-QSB).[21]

Structured Finance. The Commission also acted this past year to exempt structured finance vehicles (sometimes also called asset-backed arrangements) from the Investment

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18 During calendar year 1991, there were 1,259 Rule 504 offerings covering $377 million worth of securities. For calendar year 1992, there were 1,470 Rule 504 offerings for $434.7 million.

19 *Id.* at 36450.

20 *Id.* at 36472.

21 *Id.* at 36473, 36498.

Company Act of 1940 ("Investment Company Act"),[22] thus freeing these innovative products to be a source of capital to small business. Structured finance issuers pool income-producing assets, and issue securities backed by those assets.

The structured finance market has increased dramatically over the last decade. In 1981, there were just 17 structured finance issuances totalling $1 billion.[23] As of December 31, 1992, securities of structured financings publicly offered in the United States totalled approximately $428.6 billion, accounting for approximately 50% of total public securities offerings (debt and equity) and 57% of total debt securities offerings.[24] Most of this activity, in volume terms, relates to offerings of securities by the government sponsored enterprises like Fannie Mae and Freddie Mac.

Despite this enormous growth, the Investment Company Act constrained the development of the structured finance market. Structured finance vehicles technically meet the definition of investment company (and would, unless exempted, be subject to Investment Company Act regulation) because they issue securities and are primarily engaged in investing in, owning, or holding securities.[25] Structured financings, however, are unable to operate under many of the Investment Company Act's requirements.

In a typical structured finance arrangement, the owner of financial assets, such as a bank, sells the assets to a special purpose entity, such as a trust, that ultimately issues one or more classes of securities backed by the assets. Because the owner and the issuer often are

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22 15 U.S.C. § 80a-1.

23 David Kogut, *Corporate Finance 1985: The Red Hot Year*, INV. DEALERS' DIG., Jan. 13, 1986, at 23.

24 Calculations based on data in *How Sweet It Was!* INV. DEALERS' DIG., Jan. 11, 1993, at 14, 16-18. *See also* Figure E containing comparative data reflecting the growth of the structured finance market between 1986 and 1992.

25 *See* Investment Company Act § 3(a), 15 U.S.C. § 80a-3(a) (definition of investment company).

affiliated, the Investment Company Act would prohibit the owner's sale of assets to the issuer.[26] The Investment Company Act also frequently would preclude joint accounts where the initial owner and issuer share an interest in the excess cash flows from securitized assets.[27] These joint accounts, known as spread accounts, often are used as credit support for the financing. Finally, the Investment Company Act's limitations on senior securities and leverage would preclude the issuance of multiple classes of securities, as is common in most financings.[28]

To escape the Investment Company Act, structured financings either must fit within one of the Act's exceptions to the definition of investment company or seek exemptive relief from the Commission. Many financings rely on the exception in section 3(c)(5), which generally is available for issuers engaged in the business of acquiring notes or loans covering specified merchandise and services or interests in real estate.[29] The section 3(c)(5) exception is limited to financings involving certain types of assets, and most importantly for small business capital formation, would not permit securitization of all loans made to small business.[30]

To remove unnecessary barriers, the Commission adopted a rule conditionally exempting structured financings from regulation under the Investment Company Act.[31] The conditions of the rule seek to delineate the operational distinctions between registered investment companies

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26 *See* Investment Company Act § 17(a)(1), 15 U.S.C. § 80a-17(a)(1) (prohibiting an affiliated person of a registered investment company from selling securities to such company).

27 *See* Investment Company Act § 17(d) and rule 17d-1, 15 U.S.C. § 80a-17(d), 17 C.F.R. § 270.17d-1 (governing joint transactions involving an affiliated person of a registered investment company and the registered investment company).

28 *See* Investment Company Act § 18, 15 U.S.C. § 80a-18 (governing the capital structure of registered investment companies).

29 15 U.S.C. § 80a-3(c)(5).

30 *See* Division of Investment Management, SEC, *The Treatment of Structured Finance Under the Investment Company Act*, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 68-73 (1992).

31 Investment Company Act rule 3a-7, 17 C.F.R. § 270.3a-7. *See* Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105 (Nov. 19, 1992), 57 FR 56248 (Nov. 27, 1992).

and structured finance vehicles, permit the continued evolution of the structured finance market, and address investor protection concerns.[32]

Shelf Registration. The Commission also expanded the availability of Rule 415, the "shelf registration rule," to a greater number of structured finance transactions.[33] The "shelf registration" procedure provides issuers eligible to use Form S-3 with the flexibility to access the public securities markets on demand, without having to obtain additional clearance from the Commission staff. The Commission revised Form S-3 specifically to permit companies to register investment grade asset-backed securities without regard to their reporting history.[34] Before the revision, the benefits of Form S-3 and shelf registration for delayed offerings generally were not available to issuers of non-mortgage related investment grade asset-backed securities. As a result, for example, investment grade securities backed by small business loans or credit card receivables generally could not be registered for sale on a delayed basis, and sold as market conditions warrant. The revisions to Form S-3 removed unnecessary regulatory obstacles to the raising of capital and should reduce the costs of securitizing a variety of financial assets, including pools of small business loans. By utilizing proven techniques of securitization that have been developed in connection with mortgage-backed securities, the Commission has sought to enhance significantly liquidity for lenders to small businesses.

While it is still too early to tell what effect these measures will have, we are aware of at least two proposed offerings eligible for shelf registration currently pending with the Commission that would pool small business loans and sell securities backed by those loans.[35] Meanwhile, we have been informally told by many on Wall Street that these initiatives should

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[32] *Id.*

[33] 17 C.F.R. § 230.415. *See* Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992), 57 FR 48970 (Oct. 29, 1992).

[34] *Id.* at 48976.

[35] Fremont Funding Inc., Form S-3, Registration No. 33-55424 (filed Jan. 15, 1993); TMS SBA Loan Trust 1993-1, Form S-11, Registration No. 33-58126 (filed Feb. 10, 1993).

materially improve the efficiency of the structured finance market. Financial institutions may be able to make new loans to more small businesses if they can sell existing "securitized" loans to third parties.

<u>Small Business Incentive Act of 1993</u>.

I will now turn to the Small Business Incentive Act of 1993. This legislation is very similar to the legislation submitted to the Congress by the Commission last April, and introduced as the Small Business Incentive Act of 1992.[36] The legislation principally would amend the Investment Company Act to streamline the regulation of venture capital pools that otherwise would be subject to the full bore of regulation under the Investment Company Act. The Commission believes that these changes are necessary because companies regulated under the Investment Company Act are subject to a number of rigorous requirements ranging from registration to restrictions on capital structure and dealings with affiliated persons.

Venture capital pools often find it difficult to comply with the Investment Company Act's capital structure restrictions. For example, while the Investment Company Act requires conventional closed-end funds to have a minimum of $3 of assets for every $1 of debt,[37] venture capital pools are usually highly leveraged. The capital structure of venture pools typically are more complex than that permitted by the Investment Company Act, which only permits closed-end funds to issue one class of debt securities and one class of preferred stock.[38] These pools also find it difficult to comply with the Investment Company Act's restrictions on dealings with affiliated persons, including the prohibition against joint transactions (absent exemptive relief from the Commission).[39] Unlike traditional investment companies, venture capital pools often control the companies in which they invest. In addition, several venture capital pools may be

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[36] S. 2518, 102d Cong., 2d Sess. (1992); H.R. 4938, 102d Cong., 2d Sess. (1992).

[37] Investment Company Act § 18(a)(1)(A), 15 U.S.C. § 80a-18(a)(1)(A).

[38] Investment Company Act § 18(c), 15 U.S.C. § 80a-18(c).

[39] Investment Company Act § 17(d), 15 U.S.C. § 80a-17(d).

advised by the same persons. As a result of these relationships, joint transactions among affiliated venture capital pools are common, but would not be permitted by the Investment Company Act.

The proposed legislation would enable various types of venture capital pools to operate more freely. I will briefly discuss various types of venture capital pools and how they would be created or affected by the proposed legislation.

Qualified Purchaser Investment Pools (sections 201-203). Section 202 would amend the Investment Company Act to permit a new genre of investment pools whose securities are owned exclusively by sophisticated or so-called "qualified" purchasers. The new exception would apply irrespective of the number of investors. At present, venture capital firms may avoid the Investment Company Act only if they limit the number of shareholders to 100 and only if they do not publicly offer their securities.[40] The 100 investor limit applies regardless of the financial sophistication of the investors involved. The proposal is designed to promote capital participation in venture capital funds by recognizing that sophisticated investors can appreciate the risks associated with pooled investment vehicles, and do not need Investment Company Act protections. In other words, these investors should be able to monitor on their own behalf such matters as management fees, transactions with affiliates, governance, investment risk, and leverage. By limiting participation in the new funds to sophisticated investors, the amendment could respond to the capital needs of small businesses without jeopardizing investor protection.

Funds relying on the new exemption would have greater access to the capital markets because they would be permitted to make public offerings.[41] Investors should benefit as well from the increased liquidity of the new funds' securities.

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[40] Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).

[41] The securities offered would be subject to the registration requirements of the Securities Act, unless the offering qualified for an exemption under that Act. *See* Securities Act § 5, 15 U.S.C. § 77e. Brokers or dealers offering the securities also would need to be registered under the Exchange Act. *See* Exchange Act § 15(a), 15 U.S.C. § 78o(a).

The legislation would assign to the Commission the responsibility of defining by rule the class of sophisticated or "qualified purchasers" eligible to invest in the new pools. In response to the legislation last April, the Commission suggested that, at least initially, the definition of "qualified institutional buyer" in Rule 144A under the Securities Act[42] would be an appropriate standard for institutional participants.[43] The Commission also indicated that it would propose standards requiring a high degree of financial sophistication for any natural person investing in the new pools comparable to their institutional counterparts.[44]

Business Development Companies (sections 206-210). Business development companies, or "BDCs," are domestic closed-end funds that invest in small and developing businesses. They were made possible by amendments to the Investment Company Act in 1980.[45] Unlike traditional investment companies that invest "passively" in so-called "small cap" stocks, BDCs are required by the Investment Company Act to offer significant managerial assistance to the companies in which they invest.[46]

The Commission regulates BDCs in a manner similar to registered investment companies. BDCs, however, technically are not required to register with the Commission as

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[42] 17 C.F.R. § 230.144A. Qualified institutional buyers generally include certain types of institutional purchasers that own and invest on a discretionary basis at least $100 million in securities, any registered dealer that owns and invests on a discretionary basis at least $10 million in securities, any registered investment company that is part of a family of investment companies with at least $100 million in securities, and any bank or savings and loan that owns and invests at least $100 million and has an audited net worth of at least $25 million.

[43] 138 CONG. REC. S4822 (daily ed. Apr. 2, 1992)(Memorandum of the Securities and Exchange Commission in Support of the Small Business Incentive Act of 1992).

[44] *Id.* *Cf.* the "accredited investor" standard of Regulation D under the Securities Act, 17 C.F.R. § 230.501(a) (an accredited investor generally includes natural persons with an individual income of *only* $200,000 or joint income with a spouse of over $300,000) *(emphasis added).*

[45] SMALL BUSINESS INVESTMENT INCENTIVE ACT OF 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C.).

[46] *See* Investment Company Act § 2(a)(48), 15 U.S.C. § 80a-2(a)(48).

investment companies and generally are permitted greater flexibility in dealing with their portfolio companies,[47] issuing and pricing securities,[48] and compensating their management.[49]

Although they were conceived of as a public alternative to private venture capital firms, BDCs have not proven particularly popular. In 1992, there were only about 49 active BDCs with assets of about $2.4 billion.[50] Sections 206 through 210 of the proposed legislation are designed to make it easier and less costly for BDCs to offer securities and to invest in small businesses.

Sections 206 through 208 would create a new class of very small companies in which BDCs could invest and would relieve BDC management from making available significant managerial assistance to these companies. The Commission has been told that the time and expense involved in making managerial assistance available deters BDCs from investing in these very small companies, which often are the ones most in need of capital. This new class would include any company that has total assets of $4 million or less and capital and surplus of $2 million or less. These numbers are derived from two of the minimum requirements for listing on NASDAQ.[51] By waiving the managerial assistance requirement for investments in this new class of company (or to any other company that meets criteria prescribed by Commission rule), the amendment seeks to encourage greater BDC participation in small businesses.

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47 *See, e.g.*, Investment Company Act rule 57b-1, 17 C.F.R. § 270.56b-1 (permitting BDCs to engage in principal transactions with controlled portfolio companies).

48 *See, e.g.*, Investment Company Act § 63(2), 15 U.S.C. § 80a-62(2) (permitting BDCs to issue their securities at a price below net asset value under certain conditions).

49 *See, e.g.*, Investment Company Act §§ 57(n), 61(a)(3)(B), 15 U.S.C. §§ 80a-56(n), -60(a)(3)(B) (permitting BDCs to establish profit-sharing plans for their directors, officers, and employees).

50 *See supra* note 5.

51 The "National Association of Securities Dealers Automated Quotations System." Sections 1(c)(2) and 1(c)((3) of Part II to Schedule D of the National Association of Securities Dealers by-laws.

Section 208 would amend the Investment Company Act to permit BDCs to acquire more freely the securities of portfolio companies from persons other than the portfolio companies and their affiliated persons. Currently, BDCs must monitor their portfolios to assure that at least 70% of their assets are invested in cash, securities of financially troubled businesses, and securities of "eligible portfolio companies."[52] Eligible portfolio companies, to whom BDCs must offer their managerial assistance, are companies that do not qualify for margin listing under Federal Reserve Board regulations or companies that the BDC controls.[53] Currently, BDCs must acquire eligible portfolio company securities that do not qualify for margin listing directly from the companies or their affiliated persons.[54] The amendment would permit BDCs to acquire these securities from anyone.

Expanding the channels through which BDCs would be permitted to acquire small business securities should increase the liquidity of the securities, and perhaps make them more attractive as investments. The amendment also may enable BDCs to provide capital to a greater number of small businesses. For example, the legislation would permit BDCs to acquire the notes of small companies from financial institutions. BDCs then could sell the notes back to the companies in exchange for equity interests in the companies, thereby relieving the companies of debt.

Section 209 would permit BDCs greater flexibility in their capital structure. As such, this section would depart more profoundly from a central tenet of the Investment Company Act than any other amendment to that Act in the 53 years since its adoption. Congress should be aware that the highly capitalized and simplified "plain vanilla" capital structure the Investment Company Act now requires of investment companies was regarded a half-century ago as being

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52 Investment Company Act § 55(a), 15 U.S.C. § 80a-54(a).

53 Investment Company Act § 2(a)(46), 15 U.S.C. § 80a-2(a)(46).

54 *See* Investment Company Act § 55(a), 15 U.S.C. § 80a-54(a).

of central importance to the protection of investors.[55] Nonetheless the Commission supports these amendments because it has been persuaded that without them BDCs will continue to be unable to attract the interest of venture capitalists. The safeguards in the proposed amendments should give reasonable protection to investors in these pools.[56]

Section 209 first would amend the Investment Company Act to permit BDCs to be more highly leveraged. BDCs currently are subject to a 200% asset coverage requirement.[57] They can issue only $1 of debt for every $2 in assets. The legislation would reduce this asset coverage requirement to 110% ($1 of debt for every $1.10 in assets), under conditions designed to assure that servicing the debt is a reasonable prospect for the BDC. Specifically, BDCs taking advantage of the reduced asset coverage would be required to show a total interest and dividend income for the past 12 months that exceeds 120% of their total expenses and dividends declared for that period.

In addition, section 209 would permit BDCs to issue, without restriction, multiple classes of debt securities. BDCs currently may issue more than one class of debt only if all their debt securities are privately held or guaranteed by financial institutions.[58] The amendment would permit public investors to participate in offerings of multiple classes of debt.

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55 Participants in the Congressional hearings in 1940 that led to the enactment of the Investment Company Act frequently referred to excessive leveraging and complex capital structures as some of the principal abuses in the investment company industry, because these practices led to personal gain for insiders at the expense of public shareholders, unfair valuation of securities, and disproportionate voting rights. *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 37-38, 44, 46, 270-71, 280 (1940). In adopting the Investment Company Act, Congress also identified "excessive borrowing and the issuance of excessive amounts of senior securities" as one of the principal abuses the Act was designed to address. *See* Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7).

56 Commissioner Roberts opposes the legislative expansion of BDCs. Given the Commission's enforcement experience with these organizations, he is of the opinion that their expansion may be destructive to the small company capital formation system.

57 Investment Company Act §§ 18(a)(2), 61(a)(1), 15 U.S.C. §§ 80a-18(a)(2), -60(a)(1).

58 Investment Company Act § 61(a)(2), 15 U.S.C. § 80a-60(a)(2).

Section 209 also would allow BDCs for the first time to issue, on a stand-alone basis, warrants, options, or rights that expire up to ten years from issuance. Currently, BDCs are permitted to issue warrants, options, or rights that expire more than 120 days but less than ten years from issuance only if they are accompanied by debt securities.[59] The Commission has been unable to find a basis for this restriction.

To address the additional risks associated with the proposed capital structure amendments, section 210 would grant the Commission authority to require BDCs to supply shareholders annually with a written statement describing the risk factors associated with the capital structures. This new authority would enable the Commission to ensure that investors are given adequate information about a BDC's capital structure.

BIDCOs and Intrastate Closed-End Funds (sections 204 and 205). The Small Business Incentive Act also includes two initiatives that affect "single state" investment companies. Section 204 would facilitate the creation and operation of state regulated business and industrial development companies, or "BIDCOs." Section 205 would update the current Investment Company Act exemption for intrastate closed-end funds.

BIDCOs are designed to provide capital, and sometimes managerial assistance, to businesses located within a particular state. BIDCOs typically provide capital through direct investments or loans. While BIDCOs may assist a variety of different types of businesses, the businesses often are small, local concerns.

At least 44 states have state statutes providing for the creation of these entities.[60] Of course, these statutes vary greatly. Some are comprehensive, imposing capital requirements, conflict of interest prohibitions, and other investor protections,[61] while others are more

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59 Investment Company Act §§ 18(d), 61(a)(3)(A), 15 U.S.C. §§ 80a-18(d), -60(a)(3)(A).

60 *See, e.g.*, Del. Code Ann. tit. 5, §§ 3301-3355 (Supp. 1992); Tenn. Code Ann. §§ 45-8-201 to -225 (1991).

61 *See, e.g.*, Mich. Stat. Ann. §§ 23.1189(101) to -(1001) (Callaghan 1991).

procedural in nature, merely empowering these entities to promote the growth of businesses within the state.

Because of their extensive investments in securities, BIDCOs also frequently are subject to the Investment Company Act. The Commission has used its exemptive authority to exempt 14 BIDCOs from some or all provisions of the Investment Company Act.[62] The exemptive process costs time and money, which may discourage the formation of some -- especially smaller -- BIDCOs. Section 204 would eliminate the need for individual exemptions by creating a self-operative exemption in the Investment Company Act.

The bill would require the BIDCO's operations to be regulated by a specific state statute. To address variations in state statutes or other concerns that may arise, the Commission would have the authority, by rule or order, to impose conditions it deems necessary or appropriate to protect investors.

The legislation specifically would require that at least 80% of each offering of the BIDCO's securities would have to be sold to residents of the state where the BIDCO conducts its operations. This requirement should help assure a state's regulatory interest in BIDCOs located within the state. The 20% cushion for out-of-state sales also would provide flexibility

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[62] *See* The Idaho Company, Investment Company Act Release No. 18985 (Sept. 30, 1992); Arcadia BIDCO Corporation, Investment Company Act Release No. 16141 (Nov. 20, 1987); Valley Opportunities Inc., Investment Company Act Release No. 16037 (Oct. 6, 1987); Universal BIDCO Corp., Investment Company Act Release No. 15444 (Nov. 28, 1986); Indiana Community Business Credit Corp., Investment Company Act Release No. 14585 (June 18, 1985); Development Corporation of Montana, Investment Company Act Release No. 14122 (Sept. 4, 1984); New Mexico Business Development Corporation, Investment Company Act Release No. 13930 (May 7, 1984); Business and Industrial Development Corporation of Washington, Investment Company Act Release No. 7301 (July 28, 1972); Iowa Business Development Corporation, Investment Company Act Release No. 5585 (Jan. 23, 1969); Utah Business Development Corporation, Investment Company Act Release No. 5518 (Oct. 18, 1968); Colorado Business Development Corporation, Investment Company Act Release No. 4524 (Feb. 24, 1966); Kansas Development Credit Corporation, Inc., Investment Company Act Release No. 4319 (Aug. 9, 1965); RIDC Industrial Development Fund, Investment Company Act Release No. 4135 (Jan. 12, 1965); Pennsylvania Development Corporation, Investment Company Act Release No. 3965 (Apr. 28, 1964). Of course, other BIDCOs that can rely on one of the Investment Company Act's exemptions would not have needed or received an exemptive order.

for any "spill-over" sales that might occur, especially in offerings conducted in metropolitan areas that overlap several states.

In addition to other investor protection requirements detailed in the legislation, all BIDCO security holders would have to qualify as "accredited investors" under the Securities Act, or meet such other standard as the Commission may authorize by rule or order.[63]

The second "single state" initiative involves closed-end funds that publicly offer their securities within a particular state. These funds may invest in businesses in the state where their security holders reside or in businesses located throughout the United States. Under section 6(d) of the Investment Company Act, the Commission, upon the filing of individual applications, may exempt these intrastate closed-end funds from the Investment Company Act so long as the aggregate proceeds raised in the public offering do not exceed $100,000.[64]

The $100,000 limit was put into place in 1940. This amount should be increased to reflect more accurately the current financial requirements of companies providing capital to small businesses and others. Section 205 of the legislation would bring the exemption into the 1990's by increasing the exemption's ceiling to $10 million. It would permit the Commission to readjust this amount by rule or order.

<u>Private Investment Companies (sections 201 and 203)</u>. As I mentioned earlier, private venture capital funds rely on the statutory exception for funds that do not have more than 100 investors and do not publicly offer their securities. This provision is found in section 3(c)(1) of the Investment Company Act.[65]

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63 The proposed "accredited investor" requirement would be appropriate for the BIDCO exemption since the exemption would be limited to a specific type of issuer and would rely on state law to provide alternative regulatory protections.

64 15 U.S.C. § 80a-6(d). *See, e.g.*, Associated Life Insurance Corp., Investment Company Act Release No. 4574 (Apr. 22, 1966).

65 15 U.S.C. § 80a-3(c)(1).

The 100 investor limit is calculated through a complex test. Because of this test, private funds must be particularly vigilant about the purchase of their securities by corporate investors. When a company purchases 10% or more of a private fund's securities, that company's security holders may be counted toward the 100 investor limit.[66] If the 100 investor limit is exceeded, the fund would be subject to the full panoply of Investment Company Act regulation. Private venture capital funds, as a practical matter, may avoid this problem by limiting investments by corporate investors to less than 10% of the private fund's securities. Limiting corporate investments, of course, constrains the fund's capital growth and the availability of funds for investment in small businesses.

Section 201 of the bill would simplify the way in which the 100 investor limit is calculated. The proposal would no longer count -- under any circumstances -- the security holders of corporate, non-investment company investors. The practical effect would be to eliminate current constraints on corporate investments in private venture capital funds. This could potentially make new capital available to small businesses without any serious risk to investors.

The legislation, however, would apply the 10% limit to investments by a registered investment company in any one private fund. This would ensure that registered funds could not use private funds to circumvent application of the Investment Company Act.

Even with the new "qualified purchaser" investment company we are recommending, section 3(c)(1) will continue to be important for venture capital funds and other pooled investment vehicles whose securities are not held exclusively by qualified purchasers.

<u>Securities Act Exemptive Authority</u>. Finally, the Commission currently is authorized to exempt from the registration provisions of the Securities Act offerings of $5 million or less.[67] The Commission has used this authority to create several exemptions, including an

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[66] Investment Company Act § 3(c)(1)(A), 15 U.S.C. § 80a-3(c)(1)(A).

[67] 15 U.S.C. § 77c(b).

exemption for small public offerings (Regulation A)[68] and an exemption for certain employee benefit plans (rule 701).[69] Section 101 would permit the Commission to exempt from registration offerings of up to $10 million. This would enable the Commission to extend the benefits of its exemptive rules to more business financings, including small business financings.

Conclusion

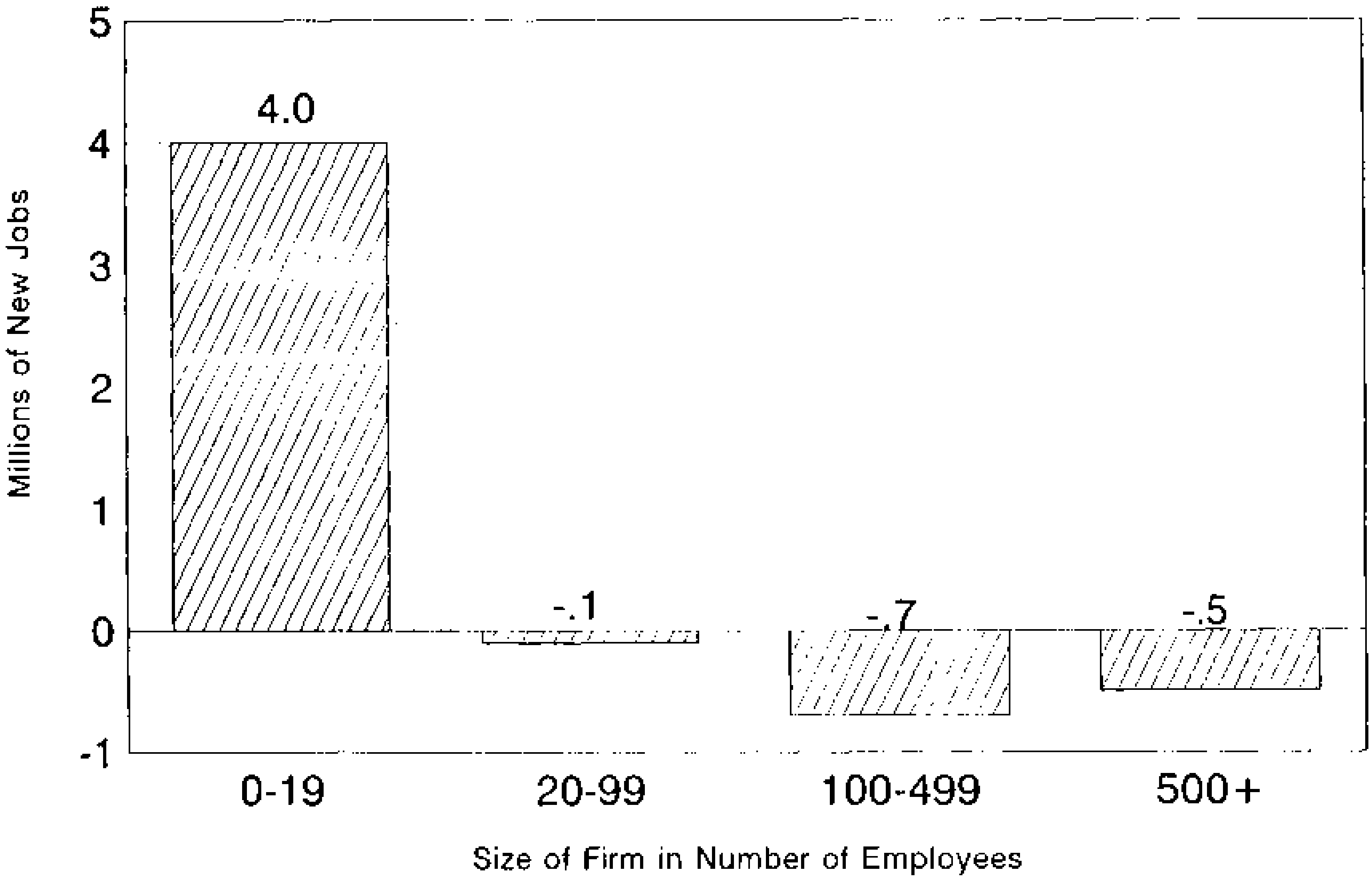
The proposed legislation combines a variety of provisions, some breaking new ground, some updating and refining existing practice. The Commission believes that, taken together, this package of reforms may help increase the flow of capital to small businesses without creating inappropriate risks to investors.

The Commission stands ready to assist the Subcommittee in this endeavor.

68 17 C.F.R. § 230.251-263.

69 17 C.F.R. § 230.701.

Figure A
Job Creation by Firm Size, 1988-1990



Source: U.S. Small Business Administration, The State of Small Business: A Report of the President 47 (1992).

Figure B
Number and Assets of Active BDCs and SBICs
1991-1992

	BDCs	SBICs
No. in 1992	49	11
No. in 1991	48	10
1992 Assets (in Billions)	$2,358.7	$331.8
1991 Assets (in Billions)	$2,463.9	$290.5

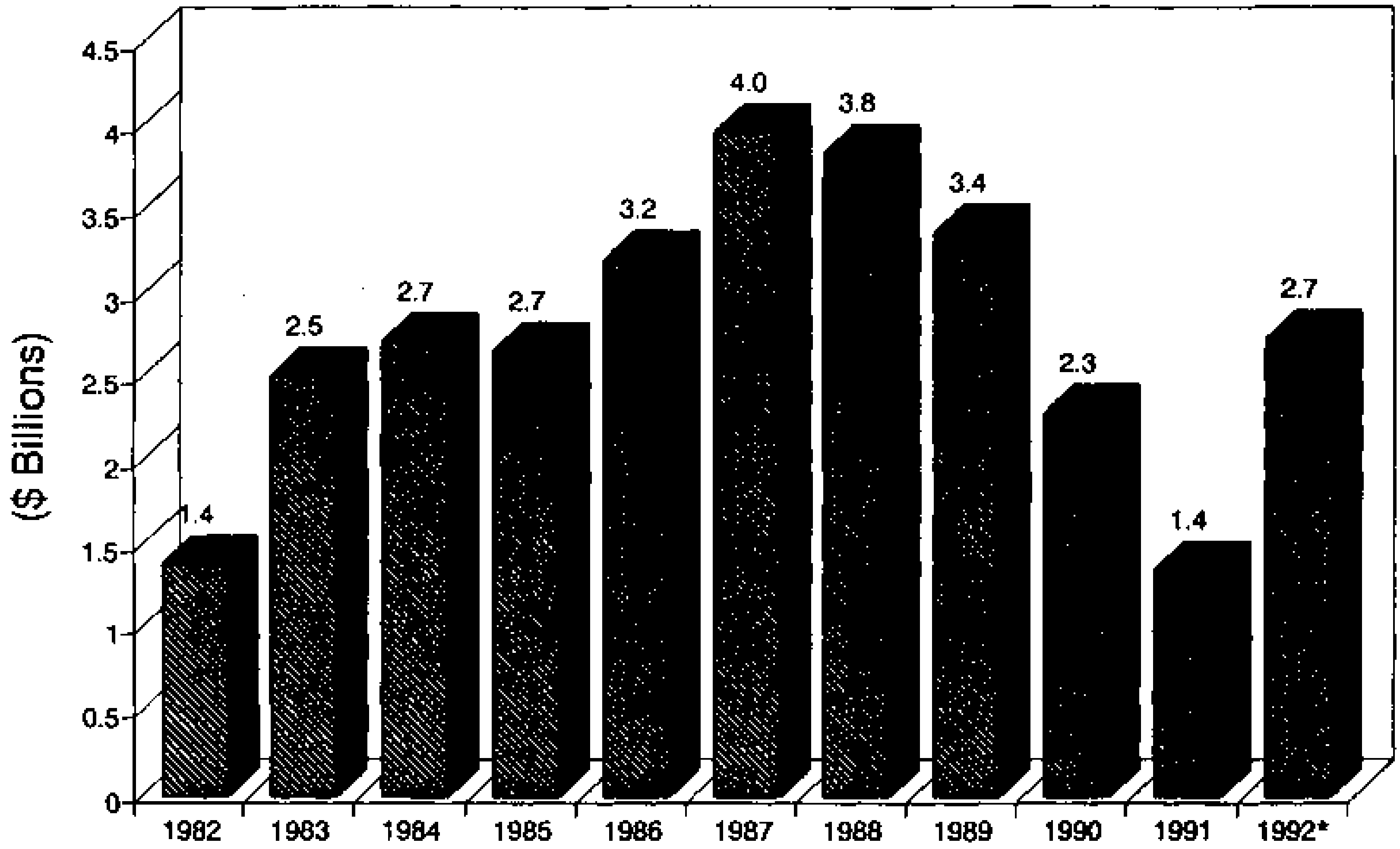
Source: Commission Records

Figure C
Growth in Small Company Open-End Mutual Funds
1991-1992

	September 1992	September 1991
No. in 1992	148	107
Assets (in Billions)	$22.1	$16.1
Net Sales (in Billions)	$3.6	$1.2

Source: Lipper Analytical Services Inc., Lipper Director's Analytical Data, Vol. II-A (4th eds.1991 and 1992).

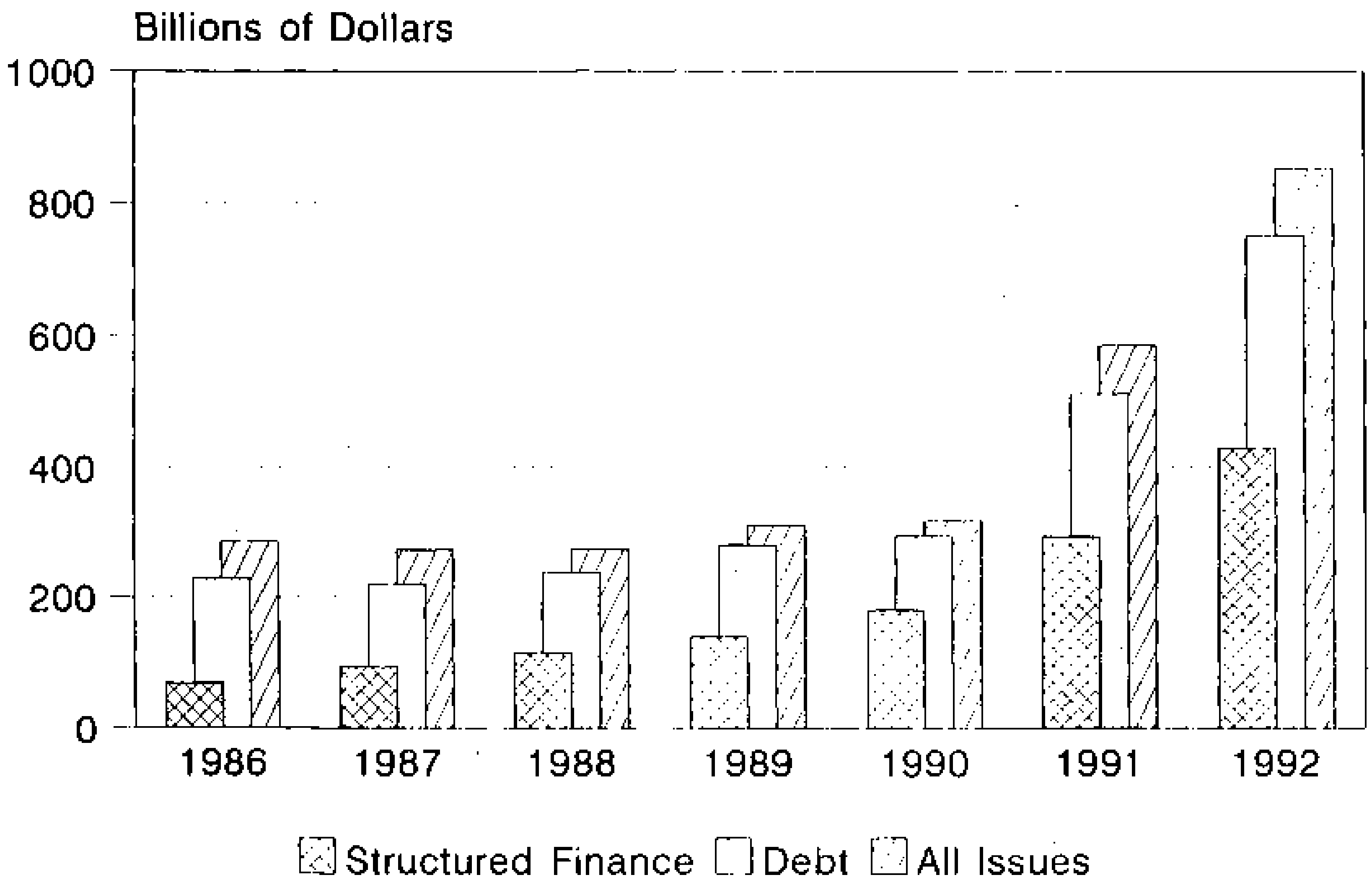
Figure D
Disbursements From Venture Capital Firms
1982-1992



* Annualized from the first six months.

Source: Venture Capital Journal, June 1992, 27 (Venture Economics Publishing Co.).

Figure E
Comparative Data Reflecting
Growth of Structured Finance in the United States 1986-1992



Sources: How Sweet It Was, Inv. Dealers' Dig., Jan. 11, 1993 at 14, 17-18; Michael Liebowitz, Reversing a four-year trend and swooning economy, Wall Street explodes in 1991, Inv. Dealers' Dig., Jan. 6, 1992 at 16, 26-27; Abby Schultz, Risk Enters the Picture in 1989, Jan. 8, 1990 at 26, 35-36; Evan Guillem, Who Survived the Crash?, Inv. Dealers' Dig., Jan. 11, 1988 at 19, 29.