FINAL REPORT

OF THE

SEC GOVERNMENT-BUSINESS FORUM

ON

SMALL BUSINESS CAPITAL FORMATION

March 2000

This report has been compiled by the staff of the Division of Corporation Finance, U.S. Securities and Exchange Commission. The views and recommendations in this report, however, are those of the Forum participants and not of the

PREFACE

In September 1999, the SEC Government-Business Forum UP Small Business Capital Formation met in Washington, D.C. The recommendations from the 1999 Forum follow. We believe that many worthwhile proposals are evidenced. Participants gave careful consideration to a wide range of issues, including, once again the recommendations of the 1995 White House Conference on Small Business.

One purpose of the Forum is to give the capital-raising needs of small business greater attention, with the hope that these needs may be accommodated, consistent with investor protection. It is apparent from the following Forum recommendations that this purpose has been well-served. We thank them for their efforts and are pleased to present this report.

The Executive Committee for the Eighteenth Annual SEC Government-Business Forum on Small Business Capital Formation

EXECUTIVE COMMITTEE

Chairman:

Richard K. Wulff
Chief, Office of Small Business
Division of Corporation Finance
U.S. Securities and Exchange Commission

Jerry Arnold
Professor of Accounting
University of Southern California

Mary E. T. Beach
Consultant (former Associate Director for Small Business at the U.S. Securities and Exchange Commission)

Charles Bennett
Vice President, Syndicate
Edgar M. Morris Company, Inc.

Janice Booker
Senior Advisor
Intergovernmental Relations
Office of the Comptroller of the Currency

Deborah Bortner
Director
State of Washington Securities Division

Michael S. Caccese
Senior Vice President & General Counsel
Association for Investment Management & Research

Chip Cooper
Executive Director

Missouri Innovation Center

Albert S. Dandridge, III
Partner, Mesirov Gelman Jaffe Cramer & Jamieson, LLP

Gregory Dean
Assistant Chief Counsel for Advocacy
U.S. Small Business Administration

Jerry Feigen
Adjunct Professor, Georgetown University Law Center;
President, Jerry Feigen Associates

Bruce Goldberg
Director
National Emerging Business Services
PricewaterhouseCoopers LLP

John J. Huntz, Jr.
Fuqua Enterprises, Inc.

Daryl Jackson
Deloitte Touche LLP

Charles Ludlam
Executive Director
Biotechnology Industry Organization

Todd McCracken
Executive Director
National Small Business United

E. Burns McLindon
Councilor, Buchanan & Mitchell
(Representative of the American Institute of Certified Public Accountants)

Lee Mercer
President
National Association of Small Business Investment Companies

Marc H. Morgenstern
Partner, Kahn, Kleinman, Yanowitz & Arnson Co., L.P.A.
(Representative of the American Bar Association)

Alien Neece
Neece, Cator & Associates, Inc.

Karen O'Brien
General Counsel
North American Securities Administrators Association

Douglas F. Parrillo
Parillo Communications, Inc.

Greg Riddle
Legislative Assistant
Biotechnology Industry Organization

Martha Scanlon
Deputy Associate Director
Division of Research and Statistics
Federal Reserve Board

Mark Schultz
Consultant

Thomas Selman
Vice President
NASD Regulation, Inc.

BettyeLynn Smith
President
National Association of Investment Companies

Wayne Upton, Jr.
Project Manager
Financial Accounting Standards Board

Clay H. Womack
President
Direct Stock Market, Inc.

OPENING PANEL
"INTERNET AND INFORMATION TECHNOLOGY TRANSACTIONS"

Moderator --

William E. Morley
Senior Associate Director (Legal)
Division of Corporation Finance
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Along with --
Michael McAlevey
Deputy Director
Division of Corporation Finance
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Suzanne Richardson
President
FBR.com Inc.
Potomac Tower
1001 Nineteenth Street North
Arlington, VA 22209

Anthony Williams
MMG Ventures, L.P.
826 E. Baltimore Street
Baltimore, MD 21202

Nancy Goldberg
Executive Vice President of Sales
CyberCash, Inc.
2100 Reston Parkway, Suite 430
Reston, VA 20191

CORE PRESENTERS

TAXATION ROUNDTABLE

Moderator --

Daryl Jackson
Deloitte Touche, LLP

333 Clay Street Suite 2300
Houston, TX 77002-4196

Along with --

Russ Orban
Assistant Chief Counsel for Tax Policy
Office of Advocacy
U.S. Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Credit
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Moderator --

Gregory Dean
Assistant Chief Counsel for Advocacy
U.S. Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Marvin Duncan
Agricultural Economist
Office of Energy Policy and New Uses
Office of the Chief Economist
U.S. Department of Agriculture
1400 Independence Avenue, S.W. Mail Stop 3815
Washington, D.C. 20250-3815

Millicent Hodge
Director of New Markets Initiatives
U.S. Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Larry Meeker
VP Community Affairs

Federal Reserve Bank of Kansas City
925 Grand Blvd.
Kansas City, MO 64198

Karl Nelson
Senior Vice President
Federal Home Loan Bank of Atlanta
P.O. Box 105565
Atlanta, GA 30348-5565

Credit
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Tuesday, September 14,1999

Moderator --

Janice Booker
Senior Advisor
Intergovernmental Relations
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Michael S. Barr
Deputy Assistant Secretary
Office of Community Development Policy
Department of the Treasury
1500 Pennsylvania Avenue, Room 2412
Washington, D.C. 20220

Michael Dowd
Director
Office of Loan Programs
U.S. Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Lester W. Johnson
Executive Vice President
The Harbor Bank of Maryland
25 W. Fayette Street

Baltimore, MD 21201-3794

Jean Wojtowicz
President
Cambridge Capital Management Corporation
8440 Woodfield Crossing Blvd. Suite 315
Indianapolis, IN 46240

Securities
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Moderator --

Charles L. Bennett
Vice President
Edgar M. Morris & Co., Inc.
15 South Main Street, Suite 810
Greenville, SC 29601

James Brigagliano
Assistant Director -- Trading Practices
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

R. Cromwell Coulson
President
National Quotation Bureau
11 Penn Plaza, 15th Floor
New York, NY 10001

Leonard Mayer
President
Mayer & Schweitzer, Inc.
111 Pavonia Ave -- Unit 15
Jersey City, NJ 07310

Daniel D. Weston
President
The League of American Investors

2804 Camino Dos Rios #205
Thousand Oaks, CA 91320

Securities
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Moderator --

Philip Feigen, Esq.
Patton & Boggs LLP
2550 M Street, N.W.
Washington, D.C. 20036

Patricia Abramson
Managing Director
Women's Growth Capital Fund
1054 31st Street, N.W. #110
Washington, D.C. 20007

Pascal Luck
Partner
Crossbill Financial Group Inc.
1825 K Street, N.W. #1450
Washington, D.C. 20006

Mark Heesen
Deputy Executive Director
National Venture Capital Association
1655 North Ft. Myer Drive, Suite 850
Arlington, VA 22209

Shelley Spencer
Vice President Law and General Counsel
AirGate PCS, Inc.
233 Peachtree Street
Harris Tower, Suite 1700
Atlanta, GA 30303

1999 FORUM STAFF

Barbara C. Jacobs, Staff Director

Regina Baker

James Budge

Michael Coco

Jonathan Ingram

Janice McGuirk

Twanna Young

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General Items of Reform for our Tax System to Help Small Businesses Raise Capital

Fundamental Tax Reform

It is the consensus of the Forum that current tax law and regulations promulgated thereunder unduly hinder the ability of small businesses to attract and maintain the capital necessary for formation and growth. It is for this reason that the Forum submits the following recommendations to promote fundamental tax reform and totally abolish the complicated present system. Congress should enact legislation that replaces the present complex tax system with a single comprehensive simple tax for individuals and businesses that eliminates double taxation. We recommend a system that encourages savings and is not difficult or costly to comply with yet raises the necessary revenue to run the government. We encourage diligent oversight by Congress to review IRS interpretations of the law but urge Congress to resist the frequent tinkering with the Internal Revenue Code.

Social Security Reform

The inaction of Congress has contributed to the instability of the current Social Security System. Congress and the Administration must work together to enact legislation by the end of 1999 to make the existing Social Security System actuarially sound and to guarantee the commitments already made to all current participants. This should be done without placing additional new burdens on the present payroll tax system.

Small Business Representation on the IRS Oversight Board

The President should act quickly to appoint the members of the IRS Oversight Board and at least one or more individuals named to the board should have extensive experience as small business owners or as representatives of small business owners as required by law. Small businesses and their employees create over 50% of the gross domestic product in the United States and provide about 40% of the cash that flows to the IRS each year. Small businesses have earned the right to full representation.

Federal Advisory Boards and Commissions -- Small Business Representation

The Forum requests that any federal advisory commission include at least one representative from the small business community. The concerns and issues that relate to small businesses must be reviewed prior to a policy paper being issued. This would create parity among businesses and other entities since many more powerful groups such as large businesses, organized labor, tax exempt organizations, and academic institutions have enjoyed a strong presence on advisory commissions for years.

Implementation of IRS Restructuring -- Behavior Modification in the Field

The Forum continues to support the IRS Reform and Restructuring Act and the goals established by Commissioner Rossotti. The Forum is still concerned that these goals have not been fully implemented in the IRS field offices. Every effort should be made to extend the positive direction of the new goals to every IRS facility and practice. A primary objective of the IRS should be to help small businesses comply with the law and fight any IRS predisposition to treat all small businesses as fraudulent. The Service should strive to apply all tax laws fairly, equitably and consistently.

The IRS should acquiesce on tax issues that it has consistently lost in litigation and be prohibited from shopping for opinions in different judicial districts or continually bringing cases with slightly different facts in hopes of getting different decisions.

Equal Treatment for Employees Under Different Business Forms

Employee benefits should be tax deductible against income in the same manner for all business organizations. The form of the business (e.g., sole proprietorship; Subchapter S corporation; partnership; Subchapter C corporation; limited liability corporation, etc.) should make no difference on deductible business expenses. For example, benefits provided to officers, directors, employer/owners such as health insurance, disability insurance, life insurance, pension plans, education benefits, training benefits, parking/commuting benefits, child care availability and any other benefit that any business is able to deduct should be equally deductible by all businesses regardless of business form.

Specific Items in the Tax System That Need Attention While We Wait for General Fundamental Reform

Independent Contractor Clarification

The Forum is concerned that Congress has not been able to come to an agreement on the independent contractor issue that is still a major concern of the small business community because of the added expense and uncertainty due to the unclear standards. The definition of an independent contractor must be clarified so that small businesses can act as independent contractors or hire independent contractors without fear of future reclassification by the IRS and the imposition of substantial penalties. Therefore, Congress should recognize the legitimacy of an independent contractor. The Forum urges Congress to pass a legislative solution to this serious small business problem, including a simplified safe harbor to insulate businesses that hire independent contractors. State independent contractor laws and rules should be in conformity with federal rules to avoid conflicting definitions.

Changes to Qualified Small Business Stock

(Internal Revenue Code Sections 1202 and 1045)

The tax rate on capital gains on Qualified Small Business Stock should be set at 50% of the rate on long-term capital gains. (For example, the long-term capital gains rate is 20% so Section 1202 stock would be taxed at an effective rate of 10%.)

Sections 1202 and 1045 should be available for investors in a "Subchapter S Corporation" and other forms of legal entities, such as Limited Liability Corporations (LLCs) and Limited Liability Partnerships (LLPs) where the subject entities meet all other requirements of Section 1202.

The Alternative Minimum Tax should not apply to investors for the purpose of computing the amount of tax on a gain under Section 1202.

Gains on Section 1202 stock should not be a preference item under the Alternative Minimum Tax.

Expenditures that qualify under the working capital rules listed in Section 1202 should be based on sound business judgment and not an arbitrary two-year spending deadline as is required under current law.

Section 1045 should be amended so that investors in qualifying small businesses would have 180 days to "rollover" investments into another qualifying business to avoid incurring a tax rather than the current 60 days.

Alternative Minimum Tax (AMT) and Small Business

The AMT is one of the costs to small business of acquiring capital. In the interest of finding ways to provide abundant capital sources to encourage small business growth, the Forum urges Congress to exempt all components of personal AMT that are generated by "small business." For the purpose of this exemption, a "small business" shall be defined as one that meets the capitalization requirement as defined by Congress in Internal Revenue Code Section 1202 dealing with special Small Business Stock (e.g., capitalization of less than $50 million).

Congress should certainly do away with the AMT as part of any comprehensive tax overhaul proposal. In the meantime, Congress should not add the AMT to any new provisions of the tax code. Congress should instead carefully review the impact of this provision on investments in small business and repeal AMT in those instances where it discourages such investments. The AMT takes capital out of circulation that could be invested in a small company. The AMT has a disproportionately damaging effect to small businesses that are competing in the market for capital because sophisticated investors with the ability to analyze and invest in small businesses are the likely targets for the AMT. The Forum urges Congress to consider that substantial risks are already inherent in small business investments.

Graduated Capital Gains (in lieu of Section 1202 reform)

In an effort to support long-term patient capital investment in qualified small business, the applicable capital gains tax rate should be phased out over a five year holding period. Each year the asset is held, the rate would reduce proportionately so that if the asset is sold after 12 months, the long-term capital gains rate would apply but the rate would reduce each year after until the rate is zero for assets held five years or more.

Electronic Commerce

Electronic commerce has become a major factor that must be addressed by small businesses in their pursuit of capitalization. The lines of taxing authority giving rights to one government jurisdiction to tax an entity located in another governmental jurisdiction (known as nexus) have become blurred with the explosive growth of electronic commerce that instantly crosses all boundaries. Without uniform international, national and state guidelines that lay out how electronic commerce will be fairly taxed, a small business will be at a continuing disadvantage in its ability to allocate its resources to meet future taxation and compliance expenses.

We request that all international government bodies, the federal government and the state governments adopt the position that until concrete, dependable and uniform guidelines are created, all taxes generated by inter-jurisdictional commerce that have or may accrue be abated.

Estate Tax

Estate taxes negatively impact small businesses in capital formation and business continuity. Therefore, the Forum calls on Congress to repeal the estate and gift tax.

Investment of Qualified Pension Funds

Current law should be modified to allow an individual to invest, under current limits, his or her own self-directed qualified pension or profit sharing plan(s) in his or her own small business. These funds could be used as a direct investment or as collateral to obtain debt financing.

Officer or director self-directed IRAs should be authorized to make investments in the obligations and other securities of their own companies.

Self-employment Tax-Partnerships

Currently, the full net earnings from a taxpayer's trade or business, including flow through entities, is subject to a self-employment tax of approximately 15%. Congress should adjust downward the definition of "net earnings from self-employment" to reflect an adjustment for a return on capital investment from the taxpayer's trade or business income, including single member Limited Liability Corporations (LLCs) and/or the taxpayer's share of self-employment income of a partnership, LLCs or Limited Liability Partnerships (LLPs) that are engaged in a trade or business. To ease the calculation, the Forum suggests that a flat rate of return on investment (e.g., 20%) be used. This would more realistically reflect actual facts and, therefore, enhance the market for investments in small business.

Net Operating Loss--The Application of Internal Revenue Code Section 382

So as not to artificially impede the acquisition, merger or other consolidation of loss companies, Congress should repeal Section 382 in cases where the company is getting capital investment and is continuing its business. The key here is the intent of the company to obtain new capital and to continue business.

Cash vs. Accrual Accounting

The Forum supports the right of small businesses with minimal inventory to use the simplest and most straight forward accounting method, generally the cash accounting method, to run their business. Congress should make it clear that unless profits from the sale of inventory are a substantial part of a business, cash accounting can be used.

Tax Recommendations Currently Under Consideration

The Forum takes note of the fact that while we are in conference considering incentives and methods to raising and preserving capital for small businesses, Congress and the President are considering a tax package, which includes the following items:

• increased deducibility for business meals;

• increased expensing under Internal Revenue Code Section 179;

• estate tax repeal and reform;

• full and immediate deducibility for health insurance for the self employed;

• reductions for capital gains; and

• reform and phasing out of the Alternative Minimum Tax.

These items have been strongly supported in the past by this annual forum and they continue to have our strong support. We urge the President and Congress to retain these items in any tax bill that is passed and signed into law in this Congress.

[Note: As of the date of this report, Congress is considering the small business tax package that was discussed at the Forum.]

CREDIT

Recommendations

Congressional support of the programs and efforts of the SBA needs to be increased in relationship to the increased responsibilities that Congress has placed upon the agency via increased mandates.

The SBA should research and develop a program to consolidate legitimate business expenses that have been financed through credit card financing. This could be accomplished under the 7(a) loan program. An interest rate ceiling (higher than the current Prime + 2 3/4) could be established for these consolidated debts, and additional fees could be paid to the banks willing to participate in this type of loan program. Guarantee coverage could be extended to 90% to compensate for these debts, which would most likely be of a higher risk nature due to a lack of collateral available to secure the existing credit card debts. In addition, Congress should relax statutory restrictions that prohibit 7(a) loans to be used for refinancing of existing debt.

The SBA should re-examine the use of the 7(a) loan program by lending institutions. In some instances, the 7(a) loan program has been used to finance major fixed asset purchases. Every attempt should be made to encourage the use of the SBA's 504 Loan Program for fixed asset financing when it is in the financial best interest of the small business seeking an SBA loan. As the 504 Loan Program was designed with a longer loan term relative to the value of the collateral, and with an anticipated appreciation of the fixed assets (i.e., collateral), it is detrimental to the financial viability of small business that banks require that a small business obtain capital for these purposes through the shorter term 7(a) program.

Although many financial institutions have developed and increased the use of credit scoring, it should not be used as the sole or primary credit evaluation tool. Many financial institutions have established a loan approval or denial response based upon the credit scoring of a small business loan application. Credit scoring is the use of sophisticated equations that evaluate a person's ability to repay a loan based upon a person's credit history, underlying collateral and anticipated cash flow. A business's ability to service the debt, its financial projections, management skills and other supportive and supplemental information included in the loan application should receive equal or greater emphasis when evaluating the loan application. A person's (or business') credit score should not be the sole or primary tool to review loan applications.

The SBA should develop new and more relevant credit worthiness evaluation tools to meet the needs of service-based (and other minimally asset-based) businesses.

The SBA should seriously review the collateral requirements of their loan programs to ensure that businesses with viable and credit worthy loan applications should not be excluded from these programs merely because they have inadequate collateral.

As the SBA is initiating efforts to review SBA loan portfolios that are managed and serviced by SBA lending institution partners, the SBA should consider implementation of the following:

• Lending institutions, which continually return SBA guaranteed loans to the SBA for non-performance, should be penalized. A continued history of returning loans should require significant penalties and serious consideration of that lending institution's participation in the SBA's loan programs.

• Lending institutions that maintain a high success rate (loan completes to term without default) for SBA guaranteed loans should be rewarded. Lending institutions that provide effective loan management and services to SBA loan recipients, resulting in the creation of new businesses or the expansion or refinancing of existing businesses should receive some sort of financial compensation.

• Lending institutions that maintain SBA guaranteed loans for the term of the loan (by not selling them off on the secondary market), provide services to the loan recipient in an attempt to ensure the success of the business should be rewarded. Lending institutions that "vest" themselves in SBA guaranteed loans should be rewarded for their efforts. Although the SBA guaranty may reduce a financial institution's risks, they should be compensated for their commitment to servicing the loan for the full term of the loan. Their willingness to maintain the loan in their current portfolio and not selling the loan off to the secondary market indicates the lending institution's desire to have a local impact on the small business community. These efforts should be acknowledged.

SBA guaranteed international trade loans require the compilation of financial data from foreign business entities. Foreign entity accounting standards many times do not comply with acceptable US accounting standards. The SBA should undertake efforts to provide adequate consideration of accounting standard differences for foreign entity accounting standards to facilitate international business transactions requiring financing.

The top 60 recommendations of the 1995 White House Conference on Small Business should be re-endorsed. In particular, emphasis should be on Recommendations: # 5A, 25 and 286.

(Note: White House Conference Recommendation #5 A seeks regulatory streamlining or the development of investment vehicles for pension funds so that public and private pension funds can more readily invest in small businesses. White House Conference Recommendation #25 makes specific recommendations with respect to SBA's loan guarantee programs. White House Conference Recommendation #286 concerns the future of the SBA. Specifically, it recommends that the Guaranteed Loan Program, the 504 Loan Program and the Small Business Development Center Program should be maintained, increased and enhanced and that the Office of Advocacy should maintain its independent role within the federal government.)

The SBA's Office of Advocacy should be made a "permanent" and "independent" agency within the budget of the SBA. Congress should appropriate funds on a permanent line item basis in the SBA's budget for the Office of Advocacy to ensure the continuity of research and advocacy services provided by the Office of Advocacy.

SECURITIES REGULATION

Recommendations

Securities Act of 1933

Exemptions

The Commission should revise Rules 502(c) and 506 of Regulation D, or craft a new Rule 509 exemption under Section 28 and Section 18(b)(3) of the Securities Act, to permit general solicitation of investors over the Internet or otherwise, provided that sales:

• are made to a maximum of 35 non-accredited investors, who have a pre-existing relationship with the issuer prior to the solicitation;

• are not made to any non-accredited investors who have no preexisting relationship with the issuer;

• may be made to an unlimited number of accredited investors, including those who have no pre-existing relationship with the issuer; and

• are made only in the maximum amount of $ 10 million in a 12-month period.

Sales, but not offers, would be counted toward the dollar limit. Offers would not be considered as a factor in applying integration analysis for purposes of this exemption or any other exemption. Regardless of the amount of time between an offering under this exemption and another offering, an offering made under this exemption would not be integrated with:

• any prior, or subsequent private offering under Section 4(2) or under Rule 506 of Regulation D, to investors having a pre-existing relationship with the issuer;

• any prior, subsequent, or concurrent offering made solely to accredited, sophisticated venture capital entities or institutional investor entities;

• any prior Rule 504 offering, Regulation A offering or registered public offering that was:

• withdrawn or otherwise not declared effective;

• declared effective, and active selling efforts were begun; however, if insufficient funds were raised to meet the offering minimum or to break escrow, all funds were returned to investors;

• declared effective, and active selling efforts were begun, however, no closing occurred, and no funds were retained by the issuer; or

• any subsequent Regulation A offering or registered public offering.

Sales, but not offers, made pursuant to any prior offering under Rule 504, Regulation A or any registered public offering, in which any funds were retained by the issuer, will be integrated with an offering under the new exemption.

The Commission should leave intact the "reasonable belief of accredited status" test articulated in Rule 5 06(b)(2)(i) and the "reasonable belief of sophistication" test articulated in Rule 506(b)(2)(ii). If a new Rule 509 exemption is adopted instead of a revision to Rule 502 and 506, then Rule 509 should include similar tests.

In order to address investor fraud concerns, the Commission could, by way of amending Rule 507, or otherwise in the new Rule 509 exemption, prohibit certain types of issuers from using the new exemption, such as:

• a foreign issuer;

• a shell corporation;

• a developmental stage company with no specific business plan or purpose, or the plan or purpose of which is to engage in a merger or acquisition with an unidentified company, or

• an issuer if any of its officers, directors, principals, 5% owners, promoters, or brokers would be disqualified under the "bad boy" provisions of Rule 262. (Care should be taken not to disqualify by rote persons who have been subject to orders for ministerial violations.)

In other words, contact with any persons (accredited or not) having no pre-existing relationship with the issuer, would not be permitted by issuers of the types noted above.

The Commission should revise the integration provisions of Rule 502(a) by replacing the six-month integration test with a two or three month test as follows: "Offers and sales that are made more than two [or three] months before the start of a Regulation D offering, or are made more than two [or three] months after the completion of a Regulation D offering, will not be considered part of that Regulation D offering, so long as..."

The SEC should reconsider the integration rules under Rule 502 to either eliminate or shorten the present safe harbor time requirements and apply the five-part test only to subsequent offerings when the prior offering has not clearly terminated.

NASAA should put up a policy statement to clarify that Rule 504 is not available for accredited investors to receive free-trading stock.

The SEC should adopt bad-boy provisions for Rule 506.

The Commission should devise a general exemption for offers used to test the waters that would allow a general communication before making a public exempt or registered offering or before a private placement.

The SEC should adopt test-the-waters provisions for all private offerings.

The SEC should adopt a rule similar to CA-1001 to allow general solicitation of accredited investors as with the Model Accredited Investor Exemption.

Small-cap securities should be included in the definition of covered securities under NSMIA.

Registration

The SEC should encourage issuers of equity securities to disclose their valuation, based upon the terms of the offering in a prospectus, in a table similar to that below. Such encouragement should be in the manner that forward-looking statements are encouraged.

[table omitted]

Securities Exchange Act of 1934

As an alternative to the reproposed Rule 15c2-11, the Securities Exchange Act of 1934 could be amended to subject publicly-held non-reporting companies whose securities trade in a public market to a lower level periodic reporting requirement. Brokers/dealers and market makers could be required to ensure on a regular basis that such information is publicly available.

The SEC should withdraw the current reproposal of Rule 15c2-11.

The SEC should study and propose a new mechanism to encourage issuers to submit information to a third-party central repository to replace the existing processes of Rule 15c2-11.

Affiliates should be prohibited from trading in secondary markets in the absence of current financial information on file at the central third-party repository.

The central, third-party repository should be accessible to the general public.

Quotation mediums should identify the information available on securities.

The SEC, NASD and states should work together to develop a regulatory policy to share information and halt trading on unusual trading activity.

The NASD should have authority to halt trading in stocks rather than have to go to the Commission to halt trading.

Liquidity for small companies should be encouraged by amending the registration provisions of the Exchange Act to facilitate limited trading of securities of small businesses through Internet matching services.

The Commission is encouraged to review the regulations promulgated under the Penny Stock Reform Act of 1992 and to consider changes to those rules to facilitate secondary trading in the securities of smaller issuers.

Any new penny stock rules that are adopted by the Commission should concentrate on the sales practices of brokers; they should not have the effect of excluding small businesses from capital formation.

To encourage the use of the electronic bulletin board market, the NASD should implement constructive improvements to the electronic bulletin board to improve liquidity and stock tradability of small companies by considering the imposition of new listing standards to include:

• a special symbol;

• special limited information standards;

• escrow of insiders' stock;

• requirement of a promotional shares escrow agreement and options/ warrants agreements; and

• an "evergreen" Form U-7.

Regulators should provide a de minimus broker/dealer exemption for "finders." A "finder" would be defined as a person who occasionally arranges for investors to acquire securities of a business.

A limited class of intermediary "Finders" should be created that can raise capital for small business offerings, especially as relating to use of the Internet. This class would include registration and qualification (satisfied via exams); "Finders" would be prohibited from handling money or registering if statutorily disqualified.

Investment Company Act of 1940

As the size of venture capital funds has increased, many of them have exceeded $100 million in assets. This has triggered a requirement for Hart Scott Rodino filings, and each filing requires a $40,000 fee. This fee is commonly passed through to the small business receiving the capital. To reduce the costs of obtaining venture capital, we propose that a separate category of transactions be created for companies of less than $50 million in total assets, and that the fee for filing in this category be set at $2,500 when transactions involve an independent venture capital fund.

Congress should pass legislation to exempt small business investment companies licensed under the Small Business Investment Act of 1958 from being regulated as investment companies under the Investment Company Act of 1940. This exemption would increase the supply of venture capital, provide an alternative regulatory scheme to the state regulation of venture capital funds and open up this lucrative field of investment to a much wider group of middle class citizens.

Other

The SEC should increase the resources dedicated to developing an on-going outreach program to educate small businesses on the duties of becoming and maintaining status as a public company, including the elaboration of information available on the SEC web site.

State agencies, the business community and practitioners should work together to establish and maintain outreach programs for small businesses.

State securities regulators are encouraged to establish uniformity of state law requirements.

The Commission should encourage all of the states to accept Form D in connection with Rule 506 offerings to satisfy state notice provisions.

State CER financial statement requirements should be consistent with SEC requirements.

The SEC should solicit interest in nominations to the Forum Executive Committee and appoint one-third of the Executive Committee each year.

Actions taken pursuant to the proposals made at the preceding three Small Business Forums should be reported to the membership no less than 30 days prior to the subsequent Forum meeting.

The deadline for distribution of the Forum Final Report should be in the first quarter.

The common resolutions of each Forum group should be presented to the group as a whole at the close of the break-out sessions.

The SEC should solicit past Forum participants for ideas about topics to be discussed at the break-out sessions in advance of the Forum to allow sufficient time to permit identification of appropriate speakers and topics.

II. INTRODUCTION

The U.S. Securities and Exchange Commission hosts an annual forum that focuses on the capital formation concerns of small business as provided in the Small Business Investment Incentive Act of 1980. Thus, the SEC Government-Business Forum on Small Business Capital Formation has assembled for 18 years. A major purpose of the Forum is to provide a platform for small business to highlight perceived unnecessary impediments to the capital-raising process. Numerous recommendations have been developed at these Forums seeking legislative and regulatory change in the areas of taxation, securities regulation, financial services and state and federal assistance. Participants at the Forum typically are small business owners, venture capitalists, government officials, trade association representatives, academics and small business advocates. While a number of different formats have been tried over the years, a very effective one for purposes of the development of recommendations for governmental action has included the use of small interactive participant groups; and in recent years, the Forum has typically included this feature. The 18th Annual Forum was held in Washington, D.C. on September 13 and 14, 1999.

The Forum is governed by an Executive Committee comprised of senior government officials and representatives of small business who have a strong interest and expertise with the issues and capital-raising problems of small business. The Executive Committee organizes, plans and implements the Forum.

The topic areas of taxation, credit and securities regulation were selected as the focus of this year's Forum. The Executive Committee had determined that the format of the morning sessions would present a variety of roundtable discussions, each devoted to one of the three targeted disciplines. Each roundtable would highlight current issues in its targeted topic area, and be moderated by a member of the Forum's Executive Committee, with a core staff of presenters and commentators comprised of several experts in the particular discipline. Because all of the roundtables would be offered concurrently, Forum participants had to select the roundtable discussion in which they wished to participate. As in prior years, time would be devoted to discussion in small interactive break-out groups in order to permit Forum participants sufficient opportunity to develop thoughtful recommendations. These groups were to be comprised only of participants who had attended a particular topic roundtable.

Welcoming remarks on behalf of the Executive Committee at this year's Forum were offered by Brian J. Lane, Director of the Division of the Corporation Finance of the U.S. Securities and Exchange Commission, and Norman S. Johnson, Commissioner of the U.S. Securities and Exchange Commission. William E. Morley, Senior Associate Director (Legal) of the Division of Corporation Finance of the U.S. Securities and Exchange Commission, then moderated an opening panel discussion entitled, "Internet and Information Technology Transactions." The panel was followed by the scheduled roundtable discussions. Charles O. Rossotti, U.S. Commissioner of Internal Revenue, gave the luncheon address. Break-out sessions among the Forum participants were conducted throughout the afternoon.

The second day's session followed the same basic format. Jere Glover, Chief Counsel for Advocacy of the U.S. Small Business Administration, presented his annual assessment of the state of small business. Dan Hill, Assistant Administrator for Technology at the U.S. Small Business Administration, then discussed Y2K and Small Business Innovative Research Program issues. The scheduled roundtable discussions then followed. Raymond R. Christman, President and Chief Executive Officer of the Federal Home Loan Bank of Atlanta, gave the luncheon address. Break-out sessions among the Forum participants were conducted throughout the afternoon.

The Forum participant break-out sessions produced 71 recommendations, all of which were finally endorsed and are highlighted in the following section of this report.

While the U.S. Securities and Exchange Commission hosts this annual convocation of small business friends and advocates, and is pleased to serve as such, it in no way seeks to sponsor or influence any of the Forum's recommendations. While a number of these matters are of substantial interest to the Commission as an institution, it takes no position on any of the recommendations. The views in this report are those of the Forum participants.

III. TAXATION

Recommendations

A. General Items of Reform for our Tax System to Help Small Businesses Raise Capital

Fundamental Tax Reform

It is the consensus of the Forum that current tax law and regulations promulgated thereunder unduly hinder the ability of small businesses to attract and maintain the capital necessary for formation and growth. It is for this reason that the Forum submits the following recommendations to promote fundamental tax reform and totally abolish the complicated present system. Congress should enact legislation that replaces the present complex tax system with a single comprehensive simple tax for individuals and businesses that eliminates double taxation. We recommend a system that encourages savings and is not difficult or costly to comply with yet raises the necessary revenue to run the government. We encourage diligent oversight by Congress to review IRS interpretations of the law but urge Congress to resist the frequent tinkering with the Internal Revenue Code.

The current federal income tax system places a financial and recordkeeping burden on small businesses. The volume of paperwork and the complexity of certain tax formulas make it impractical for proprietors to independently manage their tax reporting. Instead, small business owners must expend vital resources on tax preparation and planning services. A simplified and less cumbersome federal tax structure would benefit small businesses.

Social Security Reform

The inaction of Congress has contributed to the instability of the current Social Security System. Congress and the Administration must work together to enact legislation by the end of 1999 to make the existing Social Security System actuarially sound and to guarantee the commitments already made to all current *participants. This should be done without placing additional new burdens on the present payroll tax system.*

Any uncertainty and indecisiveness relating to the soundness of the Social Security System could have a negative impact on our nation's economy, and more specifically, on small business. A joint coordinated effort by the Administration and the Congress may be needed to ensure the stability of the Social Security System, currently, and in the future. There must be appropriate oversight to control further additional tax burdens.

Small Business Representation on the IRS Oversight Board

The President should act quickly to appoint the members of the IRS Oversight Board and at least one or more individuals named to the board should have extensive experience as small business owners or as representatives of small business owners as required by law. Small businesses and their employees create over 50% of the gross domestic product in the United States and provide about 40% of the cash that flows to the IRS each year. Small businesses have earned the right to full representation.

Appointment of individuals, with considerable small business experience to the IRS Oversight Board would provide the Board with a voice of that section of the economy that contributes significantly to our nation's economic growth. Small business owners would have representation with an agency that has a considerable impact on their ability to grow.

Federal Advisory Boards and Commissions -- Small Business Representation

The Forum requests that any federal advisory commission include at least one representative from the small business community. The concerns and issues that relate to small businesses must be reviewed prior to a policy paper being issued. This would create parity among businesses and other entities since many more powerful groups such as large businesses, organized labor, tax exempt organizations, and academic institutions have enjoyed a strong presence on advisory commissions for years.

The disparity in representation of small business interests in the area of policy formation can impede the operating success of smaller entrepreneurs because other entities may face different issues and may be unaware of particular small business concerns.

Implementation of IRS Restructuring -- Behavior Modification in the Field

The Forum continues to support the IRS Reform and Restructuring Act and the goals established by Commissioner Rossotti. The Forum is still concerned that these goals have not been fully implemented in the IRS field offices. Every effort should be made to extend the positive direction of the new goals to every IRS facility and practice. A primary objective of the IRS should be to help small businesses comply with the law and fight any IRS predisposition to treat all small businesses as fraudulent. The Service should strive to apply all tax laws fairly, equitably and consistently.

Goals have been formulated by the Commissioner of the IRS, based on the IRS Reform and Restructuring Act. The application of these goals in the field offices in a clear and consistent basis is necessary for an equitable application of the law. A positive attitude and assistance in complying with the law by the field offices would greatly enhance the ability of small businesses to be more fully informed of the tax laws. These goals should be brought to the attention of, and implemented in, the field offices as soon as possible.

The IRS should acquiesce on tax issues that it has consistently lost in litigation and be prohibited from shopping for opinions in different judicial districts or continually bringing cases with slightly different facts in hopes of getting different decisions.

Consistent application of tax issues from district would contribute to a clearer understanding and compliance with the tax laws, rules and regulations. This issue should be given immediate attention and implemented as soon as possible.

Equal Treatment for Employees Under Different Business Forms

Employee benefits should be tax deductible against income in the same manner for all business organizations. The form of the business (e.g., sole proprietorship; Subchapter S corporation; partnership; Subchapter C corporation; limited liability corporation, etc.) should make no difference on deductible business expenses. For example, benefits provided to officers, directors, employer/owners such as health insurance, disability insurance, life insurance, pension plans, education benefits, training benefits, parking/commuting benefits, child care availability and any other benefit that any business is able to deduct should be equally deductible by all businesses regardless of business form.

The form of business organization chosen by a small business can have harsh tax consequences if certain employee benefit expenses are not deductible. For example, benefits that are customarily provided to officers, directors and owners, such as health, disability and life insurance, pensions, education/training, parking, and child care may not be deductible for tax purposes by certain forms of business. The resulting increased income tax expenses may be passed through to individual small business owners.

Specific Items in the Tax System That Need Attention While We Wait for General Fundamental Reform

Independent Contractor Clarification

The Forum is concerned that Congress has not been able to come to an agreement on the independent contractor issue that is still a major concern of the small business community because of the added expense and uncertainty due to the unclear standards. The definition of an independent contractor must be clarified so that small businesses can act as independent contractors or hire independent contractors -without fear of future reclassification by the IRS and the imposition of substantial penalties. Therefore, Congress should recognize the legitimacy of an independent contractor. The Forum urges Congress to pass a legislative solution to this serious small business problem, including a simplified safe harbor to insulate businesses that hire independent contractors. State independent contractor laws and rules should be in conformity with federal rules to avoid conflicting definitions.

The uncertainty that surrounds the classification of the term "employee" versus independent contractors needs to be eliminated. From the perspective of small businesses, the determination impacts the decision whether tax withholding is necessary and if improperly decided by the employer could result in significant tax penalties.

Changes to Qualified Small Business Stock

(Internal Revenue Code Sections 1202 and 1045)

The tax rate on capital gains on Qualified Small Business Stock should be set at 50% of the rate on long-term capital gains. (For example, the long term capital gains rate is 20% so Section 1202 stock would be taxed at an effective rate of 10%.)

Tax policy should be used to encourage investments in small business. The reduced tax rate would encourage the investment of risk capital. The recommended tax rate would make the investment in small businesses more attractive to the nation's investors.

Sections 1202 and 1045 should be available for investors in a "Subchapter S Corporation" and other forms of legal entities, such as Limited Liability

Corporations (LLCs) and Limited Liability Partnerships (LLPs) where the subject entities meet all other requirements of Section 1202.

A change in the tax policy should be considered that would provide infusion of capital into the presently non-qualified small businesses and therefore encourage the growth of the small business section of the economy.

The Alternative Minimum Tax should not apply to investors for the purpose of computing the amount of tax on a gain under Section 1202. Gains on Section 1202 stock should not be a preference item under the Alternative Minimum Tax.

Persons subject to the AMT appear to be investors who are likely to be interested in the risk capital situations that exist in small and developing businesses. Repealing this tax could open an important financing source for small businesses.

Expenditures that qualify under the working capital rules listed in Section 1202 should be based on sound business judgment and not an arbitrary two-year spending deadline as is required under current law.

The need for the two-year working capital requirement is not clear. The intention of Congress was not made known, therefore, there does not appear to be a basis for the two-year period. Review of this time period should be undertaken with consideration given to the benefits of sound business judgment. This would result in immediate significant benefits for small business.

Section 1045 should be amended so that investors in qualifying small businesses would have 180 days to "rollover" investments into another qualifying business to avoid incurring a tax rather than the current 60 days.

Tax policy should be used to encourage investments in small businesses. Section 1045 encourages the investment of risk capital in small businesses by allowing taxpayers to defer gain recognition on the sale of qualified small business stock if the proceeds are used within 60 days to purchase other small business stock. The recommendation would improve the recently revised provisions to help small businesses even more by making the investment more attractive to the nation's investors.

Alternative Minimum Tax (AMT) and Small Business

The AMT is one of the costs to small business of acquiring capital. In the interest of finding ways to provide abundant capital sources to encourage small business growth, the Forum urges Congress to exempt all components of personal AMT that are generated by "small business ". For the purpose of this exemption, a *"small business" shall be defined as one that meets the capitalization requirement as defined by Congress in Internal Revenue Code Section 1202 dealing with special Small Business Stock (e.g., capitalization of less than $50 million).*

Encouraging investment in small business is sound tax policy. Elimination of the AMT on preference items derived from small business sources would provide additional capital for growth of small businesses.

Congress should certainly do away with the AMT as part of any comprehensive tax overhaul proposal. In the meantime, Congress should not add the AMT to any new provisions of the tax code. Congress should instead carefully review the impact of this provision on investments in small business and repeal AMT in those instances where it discourages such investments. The AMT takes capital out of circulation that could be invested in a small company. The AMT has a disproportionately damaging effect to small businesses that are competing in the market for capital because sophisticated investors with the ability to analyze and invest in small businesses are the likely tar gets for the AMT. The Forum urges Congress to consider that substantial risks are already inherent in small business investments.

The AMT was devised to recapture excessive tax savings by high income taxpayers. Preference items derived from small business sources should not be subject to a provision directed to high income levels. Adjustments and preference items may be especially burdensome to small entities when their potential investors are subject to taxes at both corporate and non-corporate levels.

Graduated Capital Gains (in lieu of Section 1202 reform)

In an effort to support long-term patient capital investment in qualified small business, the applicable capital gains tax rate should be phased out over a five year holding period. Each year the asset is held, the rate would reduce proportionately so that if the asset is sold after 12 months, the long-term capital gains rate would apply but the rate would reduce each year after until the rate is zero for assets held five years or more.

The proposed graduated capital gains system would benefit small business by providing increasing tax incentives if capital investments are retained for longer periods of time. The postponement and gradual decrease of the prorated capital gains tax would permit the use of additional cash funds to sustain and increase the operations of small businesses. The extended use of capital investments also would provide the potential for additional economic growth through the use and/or increase in the value of these investments in the operations of the business.

Electronic Commerce

Electronic commerce has become a major factor that must be addressed by small businesses in their pursuit of capitalization. The lines of taxing authority giving rights to one government jurisdiction to tax an entity located in another governmental jurisdiction (known as nexus) have become blurred with the explosive growth of electronic commerce that instantly crosses all boundaries. Without uniform, international, national and state guidelines that lay out how electronic commerce will be fairly taxed, a small business will be at a continuing disadvantage in its ability to allocate its resources to meet future taxation and compliance expenses.

Small business would be benefited by extending the three-year moratorium on Internet access taxes imposed by the Internet Tax Freedom Act until all legislation regarding national and state guidelines for taxing e-commerce transactions is ended. It also would benefit small business by developing national and state sales tax legislation that would eliminate the complexities of the current tax system and provide for simplified collection and payment procedures.

We request that all international government bodies, the federal government and the state governments adopt the position that until concrete, dependable and uniform guidelines are created, all taxes generated by inter-jurisdictional commerce that have or may accrue be abated.

The Internet Tax Freedom Act of 1998 does not prohibit the taxation of Internet sales nor does it apply to international transactions. The three-year moratorium created by the law was designed to abate the enactment of new tax laws by domestic taxation authorities on Internet sales transactions.

Estate Tax

Estate taxes negatively impact small businesses in capital formation and business continuity. Therefore, the Forum calls on Congress to repeal the estate and gift tax.

Inheritances and gifts to the founders of small businesses can provide a significant amount of the start-up capital necessary to finance the enterprise. Estate and gift taxes place severe limitations on the ability of entrepreneurs to maximize the capital that is essential to the success of the venture. Congress should consider a repeal of the estate and gift tax because of the disruption this tax has on the continuity of family small businesses. A repeal of this tax would encourage the growth of small businesses and further stimulate the economy. It also would provide incentives to entrepreneurs to risk the start of a new business venture and retain capital earned or invested in the business by allowing the transfer of such business to family members without incurring these taxes.

Investment of Qualified Pension Funds

Current law should be modified to allow an individual to invest, under current limits, his or her own self-directed qualified pension or profit sharing plan(s) in his or her own small business. These funds could be used as a direct investment or as collateral to obtain debt financing.

Small business would benefit by this modification since it would provide greater incentives for individuals to collectively promote the long-term profitability of the business to assure their investments for retirement purposes.

Officer or director self-directed IRAs should be authorized to make investments in the obligations and other securities of their own companies.

This change would enable officers and directors to provide a funding source for the small business and at the same promote the creation of tax-deferred retirement funds for its officers and directors.

Self-employment Tax-Partnerships

Currently, the full net earnings from a taxpayer's trade or business, including flow through entities, is subject to a self-employment tax of approximately 15%. Congress should adjust downward the definition of "net earnings from self-employment" to reflect an adjustment for a return on capital investment from the taxpayer's trade or business income, including single member Limited Liability Corporations (LLCs) and/or the taxpayer's share of self-employment income of a partners hip, LLCs or Limited Liability Partnerships (LLPs) that are engaged in a trade or business. To ease the calculation, the Forum suggests that a flat rate of return on investment (e.g., 20%) be used. This would more realistically reflect actual facts and, therefore, enhance the market for investments in small business.

Tax policy should be used to encourage investments in small businesses. Congress should enact legislation to simplify the calculation to use a flat rate of return on investment. This would: enhance the market for investments in small business partnerships; enable enterprises to retain a greater degree of capital; and encourage the investment of risk capital. This would make the investment in small business partnerships more attractive to the nation's investors.

Net Operating Loss -- The Application of Internal Revenue Code Section 382

So as not to artificially impede the acquisition, merger or other consolidation of loss companies, Congress should repeal Section 382 in cases where the company is getting capital investment and is continuing its business. The key here is the intent of the company to obtain new capital and to continue business.

Under federal tax rules, a business is generally allowed to carry back a net operating loss (NOL) to each of the three preceding three taxable years and forward to each of the succeeding fifteen years. However, NOL carryforwards are limited with regard to certain changes in ownership of the company. In some cases of ownership change, the NOL may be completely lost.

Changes in this tax provision may make investments in small businesses more attractive to investors. In addition, it could also stimulate the acquisition of small companies that are losing money.

Cash vs. Accrual Accounting

The Forum supports the right of small businesses with minimal inventory to use the simplest and most straight forward accounting method, generally the cash accounting method, to run their business. Congress should make it clear that unless profits from the sale of inventory are a substantial part of a business, cash accounting can be used.

There are typically no significant differences between the cash versus accrual method of accounting if a company does not have significant amounts of inventory or transactions where they have made sales or purchases for which cash was not immediately exchanged (i.e., no receivables or payables). Under such circumstances there would not be a significant difference between cash and accrual accounting and Congress should consider allowing such companies to maintain their books and records on a cash basis. This would simplify and minimize costs of recordkeeping during the start-up phase of a small business and allow them to put their time and effort in developing the business rather than expending time and vital resources on accounting. This also could make starting up new small businesses more attractive since there would be less recordkeeping burden.

Tax Recommendations Currently Under Consideration

The Forum takes note of the fact that while we are in conference considering incentives and methods to raising and preserving capital for small businesses, Congress and the President are considering a tax package, which includes the following items:

• *increased deducibility for business meals;*

• *increased expensing under Internal Revenue Code Section 179;*

• *estate Tax Repeal and Reform;*

• *full and immediate deducibility for health insurance for the self employed;*

• *reductions for capital gains; and*

• *reform and phasing out of the Alternative Minimum Tax.*

These items have been strongly supported in the past by this annual forum and they continue to have our strong support. We urge the President and Congress to retain these items in any tax bill that is passed and signed into law in this Congress.

[Note: As of the date of this report, Congress is considering the small business tax package that was discussed at the Forum.]

Tax policy should be used to encourage investments in small business that could further stimulate the economy. Congress should push to make as many of these changes as possible since they would stimulate investment in small business and provide incentive to entrepreneurs to risk the start-up of a new business venture. It also may help struggling/unprofitable small companies become profitable and avoid the excessive number of small companies going out of business.

IV. CREDIT

Recommendations

Congressional support of the programs and efforts of the SBA needs to be increased in relationship to the increased responsibilities that Congress has placed upon the agency via increased mandates.

The SBA has been significantly increasing its assistance to the small business community pursuant to Congressional mandates concurrent with streamlining of operations and reduction of its labor force. Since small business is the driving force behind the growth of the U.S. economy and the primary source for new job growth, proposed budgetary cuts and reductions in the budget of the SBA could be counter-productive to future economic growth and detrimental to the development of new small businesses.

The SBA should research and develop a program to consolidate legitimate business expenses that have been financed through credit card financing. This could be accomplished under the 7(a) loan program. An interest rate ceiling (higher than the current Prime + 2 3/4) could be established for these consolidated debts, and additional fees could be paid to the banks -willing to participate in this type of loan program. Guarantee coverage could be extended to 90% to compensate for these debts, which would most likely be of a higher risk nature due to a lack of collateral available to secure the existing credit card debts. In addition, Congress should relax statutory restrictions that prohibit 7 (a) loans to be used for refinancing of existing debt.

Access to capital continues to be a major problem for many small businesses. Some have resorted to self-financing their capital needs by using credit cards for short and long-term capital. This type of financing is risky and expensive. Often, the interest rates on these outstanding credit card balances are far in excess of what would be charged for conventional business loans. The SBA could address this issue by consolidating legitimate business expenses financed through credit cards by adding it as a component to its 7(a) Loan Guaranty Program. (The loan consolidation program would be similar to current student loan consolidation programs.) Congress would have to relax current restrictions in the 7(a) Loan Guaranty Program that prohibit the proceeds from being used to pay existing debt.

The SBA should re-examine the use of the 7(a) Loan Guaranty Program by lending institutions. In some instances, the program has been used to finance major fixed asset purchases. Every attempt should be made to encourage the use of the SBA's 504 Loan Program for fixed asset financing when it is in the financial best interest of the small business seeking an SBA loan. As the 504 Loan Program was designed with a longer loan term relative to the value of the collateral, and with an anticipated appreciation of the fixed assets (i.e., collateral), it is detrimental to the financial viability of small business that banks require that a small business obtain capital for these purposes through the shorter-term 7(a) program.

The SBA's Certified Development Company (504) Program provides growing businesses with long-term, fixed rate financing for major fixed assets, such as land and buildings. Interest rates on 5 04 loans are pegged to an increment above the current market rate for five-year and 10-year U.S. Treasury issues. Maturities of 10 and 20 years are available. The 7(a) loans are generally intended to encourage longer term small business financing but actual loan maturities are based on the ability to repay, the purpose of the loan proceeds, and the useful life of the assets financed. However, maximum loan maturities have been established -- 25 years for real estate and equipment and generally seven years for working capital. Interest rates are negotiated between the borrower and lender but are subject to SBA maximums; interest rates may be fixed or variable. By re-examining the use of the 7(a) Loan Guaranty Program by lending institutions, the SBA would be able to discern whether lenders are requiring borrowers to obtain capital through the shorter-term 7(a) program when they could have obtained the capital through the longer-term 504 program.

Although many financial institutions have developed and increased the use of credit scoring, it should not be used as the sole or primary credit evaluation tool. Many financial institutions have established a loan approval or denial response based upon the credit scoring of a small business loan application. Credit scoring is the use of sophisticated equations that evaluate a per son's ability to repay a loan based upon a person's credit history, underlying collateral and anticipated cash flow. A business's ability to service the debt, its financial projections, management skills and other supportive and supplemental information included in the loan application should receive equal or greater emphasis when evaluating the loan application. A person's (or business') credit score should not be the sole or primary tool to review loan applications.

The ability of a small business to repay a loan depends on a host of factors, which may or may not be reflected in credit scoring. A lender should look at credit scores as an important factor, but not a determinative one, in evaluating a loan application of a small business.

The SBA should develop new and more relevant credit worthiness evaluation tools to meet the needs of service-based (and other minimally asset-based) businesses.

The U.S. economy is rapidly shifting from a brick and mortar type business economy to a service and information-based one. Credit worthiness evaluation tools will need to be updated since service and information-based businesses do not have the typical forms of collateral that many lenders require to make loans. Advances in credit scoring and loan processing centers have helped overcome some of these problems for smaller-sized loans; however, larger-sized loans, which are needed to grow these types of businesses, may be difficult for these companies to obtain. Contract financing, receivable financing and multi-phased loan disbursement are three potential evaluation tools that the SBA might consider in developing a loan program to meet the loans needs of service-based or information-based businesses.

The SBA should seriously review the collateral requirements of their loan programs to ensure that businesses with viable and credit worthy loan applications should not be excluded from these programs merely because they have inadequate collateral.

The SBA guaranty loan programs were designed to encourage lending institutions to make loans to businesses that did not meet all of the commercial loan requirements of individual lending institutions. The loan guarantees provided by the SBA were an incentive to provide additional security to the lending institutions for making loans to small businesses that might not have met all of their credit and collateral requirements. The SBA could review its collateral requirements to determine if too much emphasis has been placed on the collateralization of SBA-guaranteed loans so that there is not much difference between the collateral requirements for an SBA-guaranteed loans and a traditional non-SBA loan. Inadequate collateral should not be an obstacle in obtaining an SBA-backed loan.

As the SBA is initiating efforts to review SBA loan portfolios that are managed and serviced by SBA lending institution partners, the SBA should consider implementation of the following:

• *Lending institutions, which continually return SBA guaranteed loans to the SBA for non-performance, should be penalized. A continued history of returning loans should require significant penalties and serious consideration of that lending institution's participation in the SBA's loan programs.*

• *Lending institutions that maintain a high success rate (loan completes to term without default) for SBA guaranteed loans should be rewarded. Lending institutions that provide effective loan management and services to SBA loan recipients, resulting in the creation of new businesses or the expansion or refinancing of existing businesses should receive some sort of financial compensation.*

• *Lending institutions that maintain SBA guaranteed loans for the term of the loan (by not selling them off on the secondary market), provide services to the loan recipient in an attempt to ensure the success of the business should be rewarded. Lending institutions that "vest" themselves in SBA guaranteed loans should be rewarded for their efforts. Although the SBA guaranty may reduce a financial institution's risks, they should be compensated for their commitment to servicing the loan for the full term of the loan. Their willingness to maintain the loan in their current portfolio and not selling the loan off to the secondary market indicates the lending institution's desire to have a local impact on the small business community. These efforts should be acknowledged.*

Action should be taken to reward lending institutions that manage successful SBA loan programs and penalize those that return SBA guaranteed loans to the SBA for non-performance. Such a program would: incentivize successful lenders, perhaps through financial compensation; spur unsuccessful lending institutions to determine whether they want to continue in the SBA loan programs; and perhaps, encourage additional institutions to embrace the programs.

SBA guaranteed international trade loans require the compilation of financial data from foreign business entities. Foreign entity accounting standards many times do not comply with acceptable US accounting standards. The SBA should undertake efforts to provide adequate consideration of accounting standard differences for foreign entity accounting standards to facilitate international business transactions requiring financing.

The SBA's International Trade Loan Program is designed to businesses that are prepared to engage in or are already engaged in international trade, or are adversely affected by competition from imports. The SBA can guarantee up to $1,250,000 for a combination of fixed asset financing and Export Working Capital Program assistance. Consideration of diverse foreign entity accounting standards by the SBA would be very helpful to small businesses involved in international trade since it could result in their realization of significant savings in tune and cost.

The top 60 recommendations of the 1995 White House Conference on Small Business should be re-endorsed. In particular, emphasis should be on Recommendations: # 5A, 25 and 286.

White House Conference Recommendation #5A seeks regulatory streamlining or the development of investment vehicles for pension funds so that public and private pension funds can more readily invest in small businesses. White House Conference Recommendation #25 makes specific recommendations with respect to SBA's loan guarantee programs. White House Conference Recommendation #286 concerns the future of the SBA. Specifically, it recommends that the Guaranteed Loan Program, the 504 Loan Program and the Small Business Development Center Program should be maintained, increased and enhanced and that the Office of Advocacy should maintain its independent role within the federal government.

The SBA's Office of Advocacy should be made a "permanent" and "independent" agency within the budget of the SBA. Congress should appropriate funds on a permanent line item basis in the SBA's budget for the Office of Advocacy to ensure the continuity of research and advocacy services provided by the Office of Advocacy.

The SBA, in general, and the Office of Advocacy, in particular, perform a valuable function and require continued support to further their mission of assisting gazelle companies in obtaining needed equity capital for business expansion and job creation.

V. SECURITIES REGULATION

Recommendations

Securities Act of 1933

Exemptions

The Commission should revise Rules 502(c) and 506 of Regulation D, or craft a new Rule 509 exemption under Section 28 and Section 18(b)(3) of the Securities Act, to permit general solicitation of investors over the Internet or otherwise, provided that sales:

• *are made to a maximum of 35 non-accredited investors, who have a pre-existing relationship with the issuer prior to the solicitation;*

• *are not made to any non-accredited investors who have no preexisting relationship with the issuer;*

• *may be made to an unlimited number of accredited investors, including those who have no pre-existing relationship with the issuer; and*

• *are made only in the maximum amount of $ 10 million in a 12-month period.*

Sales, but not offers, would be counted toward the dollar limit. Offers would not be considered as a factor in applying integration analysis for purposes of this exemption or any other exemption. Regardless of the amount of time between an offering under this exemption and another offering, an offering made under this exemption would not be integrated with:

• *any prior, or subsequent private offering under Section 4(2) or under Rule 506 of Regulation D, to investors having a pre-existing relationship with the issuer;*

• *any prior, subsequent, or concurrent offering made solely to accredited, sophisticated venture capital entities or institutional investor entities;*

• *any prior Rule 504 offering, Regulation A offering or registered public offering that was:*

• withdrawn or otherwise not declared effective;

• declared effective, and active selling efforts were begun; however, insufficient funds were raised to meet the offering minimum or to break escrow, and all funds were returned to investors;

• declared effective, and active selling efforts -were begun, however, no closing occurred, and no funds were retained by the issuer; or

• any subsequent Regulation A offering or registered public offering.

Sales, but not offers, made pursuant to any prior offering under Rule 504, Regulation A or any registered public offering, in which any funds were retained by the issuer, will be integrated with an offering under the new exemption.

The Commission should leave intact the "reasonable belief of accredited status" test articulated in Rule 506(b)(2)(i) and the "reasonable belief of sophistication" test articulated in Rule 506(b)(2)(ii). If a new Rule 509 exemption is adopted instead of a revision to Rule 502 and 506, then Rule 509 should include similar tests.

In order to address investor fraud concerns, the Commission could, by way of amending Rule 507, or otherwise in the new Rule 509 exemption, prohibit certain types of issuers from using the new exemption, such as:

• a foreign issuer;

• a shell corporation;

• a developmental stage company with no specific business plan or purpose, or the plan or purpose of which is to engage in a merger or acquisition with an unidentified company, or

• an issuer if any of its officers, directors, principals, 5% owners, promoters, or brokers would be disqualified under the "bad boy" provisions of Rule 262. (Care should be taken not to disqualify by rote persons who have been subject to orders for ministerial violations.)

In other words, contact with any persons (accredited or not) having no pre-existing relationship with the issuer, would not be permitted by issuers of the types noted above.

The Commission should revise the integration provisions of Rule 502(a) by replacing the six month integration test with a two or three month test as follows:

"Offers and sales that are made more than two [or three] months before the start of a Regulation D offering, or are made more than two [or three] months after the completion of a Regulation D offering, will not be considered part of that Regulation D offering, so long as... "

The Commission should modernize its approach to exempted transactions by beginning to focus on the purchase or sale portion of the transaction rather than the offer. This proposal constitutes a step toward revamping the "offer" analysis under the Commission's exemptive regulatory system and reflects the view that the prohibition on general solicitation is primarily designed to protect unsophisticated investors. In the Internet age, prohibiting solicitation to those highly sophisticated investors that the Commission has characterized as "accredited" hinders small business capital formation.

The SEC should reconsider the integration rules under Rule 502 to either eliminate or shorten the present safe-harbor time requirements and apply the five-part test only to subsequent offerings when the prior offering has not clearly terminated.

Changing technologies and business conditions can dramatically alter a company's business plan and prospects. Issuers may often need to raise capital in response to these rapid changes. A shorter safe harbor on integration would better reflect modern business conditions and capital markets and assist small businesses in raising additional capital.

NASAA should put up a policy statement to clarify that Rule 504 is not available for accredited investors to receive free-trading stock.

There have been a significant number of questions regarding accredited investors and Rule 504 since the February 1999 amendments. Clarification that all investors in an exempt offering made in reliance on Rule 504 receive restricted stock unless the securities are registered at the state level would be useful. A general statement regarding the general operation of Rule 504 also would be helpful.

The SEC should adopt bad-boy provisions for Rule 506.

The "bad boy provisions" of Regulation A were incorporated into Rule 505 such that Rule 505 could not be used by the issuer if the issuer or any person in a specified relationship to the issuer were subject to one of the disqualifications provided for in Rule 262 of Regulation A. Rule 506 does not contain any bad-boy provisions.

The Commission should devise a general exemption for offers used to test the waters that would allow a general communication before making a public exempt or registered offering or before a private placement.

The SEC should adopt test-the-waters provisions for all private offerings.

In 1992, the Commission adopted a "test the waters" provision in Regulation A to permit a company relying on the exemption to measure the potential interest in the company prior to preparing the required offering statement. Under this provision, if certain conditions are met, a company may issue written or oral statements asking whether investors would be interested in purchasing its securities. If insufficient interest is indicated, the company will avoid the cost of preparing an offering statement, filing it with the Commission and delivering it to investors.

Smaller companies should be allowed to try to find out if there is interest in their securities offerings before subjecting themselves to the expense of compliance with the registration or exemptive provisions of the federal securities laws. The Commission could do this by exempting communications designed to "test the waters" from registration requirements.

The SEC should adopt a rule similar to CA-1001 to allow general solicitation of accredited investors as with the Model Accredited Investor Exemption.

Rule 1001 exempts from the registration requirements of the Securities Act offers ands sales up to $5 million that are exempt from state qualification under paragraph (n) of Section 25102 of the California Corporations Code. The California law provides an exemption from state law registration for offerings made to specified classes of qualified purchasers that are similar, but not the same as, accredited investors under Regulation D. It also allows for certain types of general solicitation.

NASAA's Model Accredited Investor Exemption, which has been adopted by several states, permits solicitations similar to those permitted under the California rule. The Model Accredited Investor Exemption also provides that securities may be sold only to persons who are, or are reasonably believed to be, accredited investors as defined in Rule 501 of Regulation D.

Small-cap securities should be included in the definition of covered securities under NSMIA.

The National Securities Market Improvement Act ("NSMIA") preempts state registration and review of "covered securities." The definition of covered securities generally refers to securities that are listed on a national stock exchange or are issued under one of several exemptions from registration. The definition does not include securities that are traded on the Nasdaq Small Cap market. Nasdaq Small Cap issues are generally small, less mature companies with limited revenues, assets and capitalization. Including the securities of these entities under the definition of "covered securities" could benefit small issuers because they could avoid the expense, effort and time associated with state regulation.

Registration

The SEC should encourage issuers of equity securities to disclose their valuation, based upon the terms of the offering in a prospectus, in a table similar to that below. Such encouragement should be in the manner that forward looking statements are encouraged.

[table omitted]

Valuation is calculated by multiplying the price per share and the number of shares offered. Issuers should be encouraged to disclose their valuation in tabular format. With respect to start-ups and other early stage companies, this type of information is helpful to investors in developing an appreciation for the issuer's value.

Securities Exchange Act of 1934

The SEC should withdraw the current reproposal of Rule 15c2-11.

As an alternative to the reproposed Rule 15c2-11, the Securities Exchange Act of 1934 could be amended to subject publicly-held non-reporting companies whose securities trade in a public market to a lower level periodic reporting requirement. Brokers/dealers and market makers could be required to ensure on a regular basis that such information is publicly available.

In February 1999, the Commission reproposed for comment amendments to Rule 15c2-11, which governs the publication of quotations for securities in a quotation medium other than a national securities exchange or Nasdaq (Rel. 34-41110) to curtail abuses in the offer, sale and trading of microcap securities. The amendments are intended to have broker-dealers "stop, look and listen" before they begin to quote a covered OTC security by setting forth the quotation events that trigger the rule. The amendments also set forth the requirements that the broker-dealer must satisfy and the nature of the information that the broker-dealer must review.

Instead of focusing upon the role of broker-dealers in microcap securities, the second Rule 15c2-11 Forum recommendation suggests that companies whose securities trade in a public market have the responsibility to provide basic financial information. This could be accomplished by amending the Exchange Act to require all companies whose securities are traded in a public market to file at least limited information with the Commission on a regular basis. Broker/dealers and market makers could be enlisted to monitor compliance with that reporting requirement.

The SEC should study and propose a new mechanism to encourage issuers to submit information to a third-party central repository to replace the existing processes of Rule 15c2-11.

One of the arguments against the Rule 15c2-11 proposals is that broker-dealers are ill suited to obtain specified information about the issuer and the security. In Rel. 34-41110, the Commission noted that it had solicited comment on this concept in the initial Rule 15c2-11 proposals and that the consensus from the commenters who specifically addressed this issue was that the creation of a repository would foster access to information about issuers that do not participate in the public disclosure system. While encouraging the development of one or more repositories of Rule 15c2-11 information, the Commission noted that the existence of a repository would not be necessary for broker-dealers to comply with the rule.

Affiliates should be prohibited from trading in secondary markets in the absence of current, financial information on file at the central, third-party repository.

Fraudulent trading activities in secondary markets by affiliates of issuers may be more likely where affiliates are able to trade on the basis of financial information that is unavailable to the public. When affiliates could only trade where there was current financial information on file at a central, third-party repository, a level playing field would be established. Small businesses and investors alike would benefit.

The central, third-party repository should be accessible to the general public.

Public access to a central, third-party repository would eliminate informational asymmetries in the microcap market.

Quotation mediums should identify the information available on securities.

In order to make informed investment decisions, investors need to know whether information is publicly available about a company, and if so, the type and frequency of such information.

The SEC, NASD and states should work together to develop a regulatory policy to share information and halt trading on unusual trading activity.

Currently, the SEC, NASD and the states coordinate their efforts to share information and halt trading on unusual trading activity. If they were to further develop this regulatory policy, perhaps through a memorandum of understanding, there would be earlier detection of potential trading problems and more consistent regulatory enforcement. Everyone would benefit from a more cooperative environment -- businesses of all sizes, regulators, market professionals and investors.

The NASD should have authority to halt trading in stocks rather than have to go to the Commission to halt trading.

By giving power to the NASD to halt trading in stocks, this self-regulatory organization would be able to provide a more rapid response to highly suspect trading activities.

Liquidity for small companies should be encouraged by amending the registration provisions of the Exchange Act to facilitate limited trading of securities of small businesses through Internet matching services.

Liquidity is a crucial consideration of issuers and investors who use alternative offering vehicles. The Internet is one example of such a vehicle.

The Commission is encouraged to review the regulations promulgated under the Penny Stock Reform Act of 1992 and to consider changes to those rules to facilitate secondary trading in the securities of smaller issuers.

The additional requirements imposed by the Commission on penny stocks as a result of this legislation impacts small companies disproportionately and hurts liquidity by discouraging brokers from handling these securities. The regulatory system needs to be reviewed with a view to relieving burdens on small companies.

Any new penny stock rules that are adopted by the Commission should concentrate on the sales practices of brokers; they should not have the effect of excluding small businesses from capital formation.

Improper broker practices should be addressed and regulated. Small companies should not bear the brunt of compliance requirements that really have little to do with their businesses, any only incidentally with their attempts to raise funds.

To encourage the use of the electronic bulletin board market, the NASD should implement constructive improvements to the electronic bulletin board to improve liquidity and stock tradability of small companies by considering the imposition of listing standards to include:

- *a special symbol;*
- *special limited information standards;*
- *escrow of insiders' stock;*
- *requirement of a promotional shares escrow agreement and options/ warrants agreements; and*
- *an "evergreen" Form U-7.*

The recommended requirements would make the market a better one and instill confidence in investors who decide to invest in the kinds of companies whose securities trade in such a market. In turn, liquidity will be enhanced because other investors may be more willing to purchase in secondary transactions because of the added protections built into the market.

Regulators should provide a de minimus broker/dealer exemption for Finders. A Finder would be defined as a person who occasionally arranges for investors to acquire securities of a business.

Subjecting every intermediary who puts investors together with investment opportunity to the full scale regulation of the broker-dealer rules and regulations may deprive small businesses of important capital-raising possibilities. A person providing very limited service should be subjected to a lower level of regulatory oversight, if any is deemed necessary.

A limited class of intermediary "Finders" should be created that can raise capital for small business offerings, especially as relating to use of the Internet. This class would include registration and qualification (satisfied via exams); "Finders" would be prohibited from handling money or registering if statutorily disqualified.

The development of an authorized category for persons providing assistance to businesses by finding investors for their securities should be encouraged. The establishment of this category of intermediary "finders" specializing in these securities could benefit small businesses.

Investment Company Act of 1940

As the size of venture capital funds has increased, many of them have exceeded $100 million in assets. This has triggered a requirement for Hart Scott Rodino filings, and each filing requires a $40,000 fee. This fee is commonly passed through to the small business receiving the capital. To reduce the costs of obtaining venture capital, we propose that a separate category of transactions be created for companies of less than $50 million in total assets, and that the fee for filing in this category be set at $2,500 when transactions involve an independent venture capital fund.

The fee associated with Hart Scott Rodino filings makes it particularly costly for small businesses to engage in the kind of venture capital-raising activities that they typically need. It is appropriate to create a lower fee for transactions by smaller businesses that is more proportional to their size and will assist these companies by reducing the costs of obtaining venture capital.

Congress should pass legislation to exempt small business investment companies licensed under the Small Business Investment Act of 1958 from being regulated as investment companies under the Investment Company Act of 1940. This exemption would increase the supply of venture capital, provide an alternative regulatory scheme to the state regulation of venture capital funds and open up this lucrative field of investment to a much wider group of middle class citizens.

The revitalized SBIC program is adequately regulated by the SBA. Congress should seek relief for these companies from the additional regulation imposed by the 1940 Act. Reducing regulation would increase the supply of venture capital and open this field of investment to middle class citizens.

VI. OTHER

The SEC should increase the resources dedicated to developing an on-going outreach program to educate small businesses on the duties of becoming and maintaining status as a public company, including the elaboration of information available on the SEC web site.

State agencies, the business community and practitioners should work together to establish and maintain outreach programs for small businesses.

Since 1996, the Commission has hosted a series of SEC Small Business Town Hall Meetings across the United States to convey the basic requirements of raising capital under the federal securities laws to small business owners, venture capitalists, and advocates of small businesses. Through December 31, 1999, 15 of these meetings have been held. Speakers at these meetings not only include senior representatives of the Commission, but also senior representatives of the U.S. Small Business Administration, state securities commission, local Ace-Net operators and the like. A continuous outreach program could provide information and assistance to small businesses, which would reduce the risk of inadvertent non-compliance with federal or state securities law requirements when they raised capital.

State securities regulators are encouraged to establish uniformity of state law requirements.

Greater coordination of requirements among the states is desirable because it would simplify and reduce the cost of compliance by issuers. For example, considerable savings would result if an issuer could prepare a document with reference to one set of uniform regulations to satisfy all state regulators.

The Commission should encourage all of the states to accept Form D in connection with Rule 506 offerings to satisfy state notice provisions.

Section 18(c) of the Securities Act allows states to continue to require notification filings for securities transactions that are otherwise exempt from state oversight. Offerings under Rule 506 of Regulation D fit into this category. Some states require differing types of notification when a company engages in a Rule 506 offering. It would be beneficial to small companies if all states were required to accept Form D to satisfy their notification requirements.

State CER financial statement requirements should be consistent with SEC requirements.

Consistent financial statement requirements by the SEC and the state coordinated equity review would reduce the costs of compliance and should be encouraged.

The SEC should solicit interest in nominations to the Forum Executive Committee and appoint one-third of the Executive Committee each year.

There could be a broader cross-section of small business persons and interests represented if the SEC solicited interest in Executive Committee nominations and staggered appointments.

Actions taken pursuant to the proposals made at the preceding three Small Business Forums should be reported to the membership no less than 30 days prior to the subsequent Forum meeting.

Advance notice of action taken pursuant to proposals made at prior Forums would allow participants to prepare more effectively for the upcoming Forum and prevent unnecessary repetition of proposals from prior Forums if satisfactory action had been taken. It also would give participants the opportunity to make further proposals to change unsatisfactory actions made pursuant to previous proposals.

The deadline for distribution of the Forum Final Report should be in the first quarter.

Early distribution of the Final Report would expedite the process of addressing the issues raised at the Forum.

The common resolutions of each Forum group should be presented to the group as a whole at the close of the break-out sessions.

Presentation of the resolutions of each break-out group to the group as a whole would inform all Forum participants of the issues of concern that had been discussed. This would avoid the situation in which participants learn of the issues only when they receive the ballot of proposed recommendations on which they are asked to determine the final recommendations to be included in the Final Report.

The SEC should solicit past Forum participants for ideas about topics to be discussed at the break-out sessions in advance of the Forum to allow sufficient time to permit identification of appropriate speakers and topics.

If the SEC were to request that past Forum participants identify topics to be addressed at the break-out sessions, those discussions could more efficiently address the concerns of the participants. The identification of appropriate speakers on those topics would further enhance the exchange of ideas between the private sector and government agencies.