The Small Business Investment Act of 1958 and the SEC

Address by
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The prospectus for this meeting suggests that it is my task to tell you about the experience of the Securities and Exchange Commission with respect to the organization and financing of investment companies licensed under Public Law 85-699, the Small Business Investment Act of 1958. While we have received a fair number of inquiries, only one small-business investment company has filed with the Commission and this was limited to a simple Notification of Registration under the Investment Company Act of 1940. Nor has any such company, to our knowledge, sought to secure capital funds from the public in a manner which would subject it to our scrutiny. Our experience has, therefore, been extremely limited.

Close collaboration between the Small Business Administration and the Commission prior to and since the enactment of Public Law 699 and participation by the Chairman and staff of the Commission with officials of the Small Business Administration in a number of meetings on the new law throughout the country have made possible some understanding of certain problems which may arise under the securities acts in the organization, financing and operation of the new investment companies. And considerable thought and effort have been expended in the Commission in the development of basic working procedures. All of these I propose to discuss with you.

While the tremendous attendance at the regional meetings on the new legislation suggests that it is a "best seller," the questions put at these meetings suggest also that there are problems, the full nature and solution of which will depend upon developing experience with these companies in actual operation. Before discussing the problems we can now identify, it may be appropriate to review briefly at least one aspect of the legislative history of the Act.

Public Law 699 is the culmination of agitation over a long period of time for Federal legislation specifically fashioned to provide, or to encourage the provision of, equity capital and other long-term funds for small-business firms unable to obtain such financing on reasonable terms from other sources. While Section 102 of the new Act makes it clear that this is the primary legislative purpose, it also enunciates a basic policy that this important program be accomplished "in such manner as to insure the maximum participation of private financing sources." Mr. McCallum will tell you, I am sure,that, while the Small Business Administration will entertain proper requests for the loan of government funds, the operations of the Administration will be guided by the Congressional direction that maximum participation of private capital be encouraged. Of course, this also means that, in carrying out its responsibilities, the SEC should also be mindful of this carefully stated policy. This is, however, nothing new to the SEC. Those of you who have been doing business with the SEC over the years know that the Commission has always been sensitive to the special problems in this area and, in the exercise

of its authority and responsibility under the Securities Act, has weighed carefully the need for protection of the overlapping investor and public interests with the desirability of accommodating, within the framework of these statutory aims, the problems of smaller firms in raising limited amounts of capital from the public.

To provide the Commission with specially designed tools, certain additional authority and corresponding responsibility are vested in the Commission by the new Act. The significance of this lies not so much in the grant of new authority as it does in the decision of the Congress, despite important and insistent recommendations for a different approach, that, while private capital should be encouraged to participate in the new program by the extension of tax and other advantages, it is necessary to preserve and to apply with only limited exception the basic standards and requirements of the securities acts to the extent and so long as these new companies seek to attract or to use the funds of public investors. Put another way, the Congress considered and rejected the notion, long discredited but lingering, that the rules of fair play in the securities markets, which the Federal securities acts represent, in some way impede financing by small business. The new law reflects the view that economics and fiscal policies, not securities laws, affect the flow of funds to such companies.

Because many new small-business investment companies will seek to attract the funds of public investors or will attempt to avail themselves directly or indirectly of existing pools of such funds, consideration must be given at least to the provisions of the Securities Act of 1933 and of the Investment Company Act of 1940. Since the statutory scheme also involves the issuance by and to these new investment companies of debt securities, we must also consider the Trust Indenture Act of 1939. While questions may arise under other Federal securities statutes administered by the Commission, these questions have not as yet been fully formed or recognized. Public Law 699 is expressly directed only to the three acts mentioned.

The Securities Act of 1933 is, as you know, concerned with the offering and sale of securities to the public and with the prevention of fraud and deceptive practices in the sale of securities generally. This is accomplished primarily by requiring that most public offerings be preceded by the filing with the Commission of a registration statement, and that investors be furnished a prospectus containing information considered necessary to informed and independent investment decision. The Trust Indenture Act supplements these requirements by requiring that debt securities publicly offered in excess of specified amounts be the subject of an indenture which requires an independent and qualified trustee who will, in the event of default, act for the security holders as a prudent man would in the conduct of his own affairs. The Investment Company Act is, of course, a regulatory statute prescribing standards governing certain activities of companies engaged in the business of buying, selling, investing and holding securities.

Other speakers will discuss with you the mechanics of registration and problems of enforcement and will describe in somewhat greater detail the provisions of these statutes. I shall limit myself to an identification of the situations which will bring these provisions into play and to a brief discussion of certain of the exemptions from registration under each of these statutes which may be of significance. Note should be made, however, at this time of the fact that the Commission has adopted Form N-5 based upon a somewhat new approach which is a reflection of the Commission's desire to meet the needs of the new investment companies within the relevant statutory requirements. Form N-5 is so designed as to permit its use as a registration statement under both the Securities Act and the Investment Company Act or under either statute alone. We hope that it will prove as simple in use as it seems in principle. Its provisions are such that nearly all of the required information will be available from the data already assembled and presented to the Small Business Administration in the application for preliminary approval which is a requisite to the formal application for a license from that agency and to the use of Form N-5 or of our Regulation E which I shall describe in a few moments. To implement further the decision reached by the Small Business Administration and the Securities and Exchange Commission that duplication be eliminated wherever possible, the staffs of both agencies are now engaged in exploring the possibility of developing a single form of periodic report which will satisfy the requirements of each agency.

Questions under the securities acts arrange themselves into three general categories:

(1) When and to what extent are these new companies subject to the provisions of the Investment Company Act of 1940?

(2) To what extent will their organization and initial financing be subject to the provisions of the Securities Act and the Trust Indenture Act, and

(3) To what extent will the operations of these companies, as contemplated by the Public Law 699 and as the probabilities suggest, be subject to these statutes?

Public Law 699 recognizes that the new investment companies will be subject generally to the provisions of the Investment Company Act of 1940 unless one of the exemptions or exceptions provided for in the 1940 Act is available. Apart from the provisions of Section 3(c)(1) of the 1940 Act, no exemption or exception would normally be available. Public Law 699, however, does provide that certain provisions of Section 18 of the 1940 Act shall not apply to these companies; that is, under the provisions of the newly added Section 18(k); small-business investment companies need not have the generally required asset coverage of 300 per cent upon the issuance of debt securities and they will not be prohibited from declaring dividends on their capital

stock when the statutory asset coverages are not maintained on the publicly held debt securities. In view of the special problems in this area, regulation and control of the debt structure are left to the Small Business Administration, which will have the responsibility of seeing to it that sound capital structures are maintained in accordance with the policies and provisions of Public Law 699. It is important, therefore, to examine the provisions of Section 3(c)(1) of the 1940 Act.

Section 3(c)(1) provides that an investment company is excepted from regulation under the 1940 Act if its own outstanding securities are beneficially owned by not more than 100 persons and if it is not engaged in making or is not proposing to make a public offering of its securities. It is important to note that these conditions are in the conjunctive. Both must be present. Consequently, if a public offering is taking place, or is proposed, or if the company has more than 100 shareholders, registration under the 1940 Act is required. And, in calculating the number of beneficial owners of the securities of the investment company, the beneficial owners of the securities of any other company, which owns 10 per cent or more of the voting securities of the investment company, must be treated as if each were a direct beneficial owner of the investment company securities.

Many small-business investment companies will doubtless be financed privately by a limited group of persons, thus bringing them within the exception. If, however, one or several corporations with more than 100 stockholders of their own organize an investment company, registration under the 1940 Act will be required even though no public offering is involved. Since the factors which are of consequence in reaching a determination whether a public offering is involved are the same under the 1940 Act and under the Securities Act, discussion of this question will be deferred for a moment.

The Investment Company Act is long and involved, not only because it is quite detailed and specific in its requirements but also because it covers a number of different situations and considerations. Many of these have no bearing upon the new small-business investment companies. These companies will have no concern, for example, with provisions relating to open-end mutual funds, face-amount certificate companies and periodic payment plan companies.

One of the provisions which relates to our discussion, however, should be kept in mind. The Act requires that, before a public offering of investment company securities may be made or completed, an initial $100,000 in net worth must be raised either privately or from not more than twenty-five persons as part of a public offering. This requirement is intended to assure that financially responsible persons will organize these companies which manage the investments of the public. As to the specific mechanics of complying with this $100,000-capital requirement as part of a public offering, the staff of the Commission has prepared a memorandum dealing with the organization of an investment company and will be glad to furnish a copy of it upon request.

We turn now to the second category, the impact of the Securities Act of 1933 and the Trust Indenture Act of 1939 on the initial organization and financing of these investment companies. If any portion of the capital of the new company is raised by means of a public offering of securities, registration under the 1933 Act may, of course, be required and, if the securities offered are debt securities, an indenture may have to be qualified under the 1939 Act. We have already adverted to the availability of Form N-5 for registration purposes. Where such an offering will not exceed $300,000 in amount in any one year, relief from the provisions of Sections 5 and 11 is available.

All of you are familiar with Section 3(b) of the Securities Act, which authorizes the Commission to exempt from registration, upon appropriate terms and conditions, public offerings not in excess of $300,000. The Commission has adopted a number of regulations under this authority, the principal one being Regulation A. None of these regulations is available, however, to investment companies, and therefore is of little consequence so far as any offerings by the new investment companies are concerned, at least of their own securities. Section 3(b) and Regulation A should be borne in mind, however, when we discuss the disposition of the securities of small-business firms, acquired by the new investment companies in making equity and loan capital available.

To provide specific authority in the Commission to exempt limited offerings by new investment companies of their own securities, the 1958 Act added a new Section 3(c) to the Securities Act. This section empowers the Commission to exempt, subject to terms and conditions, any offering by a small-business investment company if the Commission "finds, having regard to the purposes of that Act, that the enforcement of this Act with respect to such securities is not necessary in the public interest and for the protection of investors." Pursuant to these provisions, the Commission has adopted Regulation E, which was patterned after Regulation A but was developed to deal with the special disclosure problems involved in assessing the securities of the new investment companies. While Section 3(c) places no ceiling on the permissive amount of an exemption, Regulation E is limited to offerings not in excess of $300,000 in any one year. Should the Commission's experience indicate the need for or desirability of an exemption for offerings somewhat larger in amount, the Commission will undoubtedly give careful consideration to an appropriate amendment of Regulation E. It is probably unnecessary to remind you that the availability and use of an exemption under Regulation E do not afford an exemption from registration under the Investment Company Act which would be required by virtue of the public offering so made.

Another exemption from registration normally considered in the financing of small business--the intrastate exemption provided by Section 3(a)(11)--is, by express provisions of the Investment Company Act, not available to investment companies. But, as in the case of Regulation A,

it may be useful in connection with any disposition of securities of small-business firms acquired by the new investment companies which would be subject to the registration provisions of the Securities Act.

Probably the most important exemption to be considered in the organization and financing of the new small-business investment companies, and, as we have noted, an exemption which would in many cases also make unnecessary registration under the 1940 Act, is afforded by the second clause of Section 4(1)--transactions by an issuer not involving a public offering. An understanding of the nature, and of the limitations, of this exemption will also prove helpful in considering whether the business operations of the investment company will raise questions under the securities acts. It is appropriate, therefore, to consider this exemption with some care.

It should be noted that the exemption afforded by Section 4(1) is not an exemption of a security but is an exemption limited to certain transactions in securities. In common parlance, the language of the section has been turned around so that instead of referring to transactions not involving any public offering, reference is usually made to "private transactions" or "private offerings."

The question whether a public offering is involved in any particular case is not easy to answer. It is a question of fact in the resolution of which all of the surrounding circumstances must be considered. It cannot be answered solely upon the basis either of the number or class of persons to whom the securities are offered or the number of persons with whom sales transactions are concluded. The Supreme Court has told us that the number of persons to whom the security is offered is not necessarily determinative and that in fact an offering to a limited number may be a public offering. However, it is undoubtedly still true that the scope of the offering is a factor to be considered. This involves a consideration not only of the persons to whom an express offering is made but all persons to whom an "offer" in the statutory sense is made. Preliminary conversations, the solicitation of offers to buy or even of indications of interest, or any attempt of any kind to dispose of a security, are all within the meaning of the term.

The relationship of the offerees to the issuer is significant in determining whether or not an exemption is available under Section 4(1). An offering to a class of persons who are intimately familiar with the business and affairs of the issuer is less likely to involve a public offering than one made to persons having no special knowledge in this respect. The Supreme Court, in S.E.C. v. Ralston-Purina Co., 346 U.S. 119 (1953), indicated that the availability of the exemption depends upon whether the particular persons affected need the protection of the Act. The Court stated that "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'"; that the "exemption question turns on the knowledge of the offerees. . ."; and that "The focus of inquiry should be on the need of the offerees for the protection afforded by registration." The effect of this decision

is to limit the applicability of the exemption to an offering to persons who are in a position to have such knowledge of the business and affairs of the issuer as would be substantially comparable to that which would be provided by the registration statement.

Another factor which must be considered in determining whether a given issue is entitled to an exemption as a private issue is the size of the offering and the number of units offered. Frequently, a large issuer will place a sizable issue of debt securities with a comparatively few institutional investors. Because of the ability of such institutions to insist upon and to receive information even more extensive than that usually provided in a prospectus and to negotiate the transaction on equal terms, such private placements, as they are called, can be effected within the limitations of the exemption provided by Section 4(1).

On the other hand, the placing of an issue of stock consisting of a large number of units with a relatively small group under circumstances which indicate probable re-offering and resale, in whole or in part, to a larger group would suggest the unavailability of the exemption under Section 4(1). In such a case, the initial purchasers would be underwriters as that term is defined in Section 2(11) of the Act because they would have "purchased from an issuer with a view to . . . the distribution of any security," and therefore no exemption would be available under Section 4(1), either for such persons or for the issuer. To meet this problem, an issuer will usually require the purchasers in a private offering to furnish a written representation that they are taking the securities for investment and not for the purpose of distribution. This precaution is a salutary one since it causes both parties to the transaction to give thought to the intentions of the purchaser. However, such a representation should be a serious one and not given perfunctorily to set the basis for a formal claim to exemption, since the mere presence of such a representation is not conclusive. The surrounding facts and circumstances may be such as to raise a question as to the actual intention of the purchaser. This is illustrated by the question reasonably arising when a person who is in the business of buying and selling securities (whether immediately or after seasoning) represents that he is acquiring securities of an issuer for investment and not for resale.

Relating these criteria to the organization and initial financing of investment companies, it may be safely concluded that the issuance of subordinated debentures or other notes of the Small Business Administration would be deemed to be a private transaction. I have no information that the Government intends to dispose of these securities in the capital markets. So also, the issuance of securities to a small group of promoter-sponsors or organizers of the new investment company would undoubtedly be deemed as not involving a public offering if those persons do not take the securities with a view to their distribution and the sale to them may fairly be considered as separate from and not integrated with any other offering of securities. As to transactions wider in scope, I would suggest you talk or write to us in Washington or in one of our regional or branch offices.

We may now turn to the third category which, in many respects, presents the most difficult problems. As Mr. McCallum will tell you, the Small Business Administration will license the new investment companies upon condition that they provide capital to small business upon the issuance of convertible debenture bonds or other notes. Public Law 699 requires that, in connection with such advances, the small business must purchase certain minimum amounts of the stock of the investment company, the actual amount depending upon the aggregate of debenture bonds so issued. Whatever the merits of this provision, it has the effect of requiring the investment company to negotiate the sale of its stock on a continuous basis--or at least as long as it continues to advance funds to small businesses--an activity which might be deemed to involve a public offering of its stock. If this were so, a company which was not otherwise making or proposing a public offering of its securities would thereby become subject to the registration and prospectus provisions of the Securities Act and the Investment Company Act.

In recognition of the fact that this activity is enforced by statute, is not employed by the investment company as a capital-raising device, and undoubtedly was not intended by the Congress to trigger the registration provisions of the securities acts, at least so far as the transaction between the investment company and small-business firms is concerned, the Commission has adopted essentially identical rules under the 1933 and 1940 Acts--Rules 151 and N-3C-1--defining the negotiation and sale of stock in this manner as not involving a public offering if the business firm takes the investment company stock for investment. Since small-business firms will undoubtedly be more eager for cash than for stock,it is perhaps not unlikely that the stock so received will soon find its way into the market. If, therefore, provision is not made for repurchase of these shares by the investment company and the business firms should take the securities with a view to their resale, a broad offering of the stock to the general public might result. Under such circumstances, consideration must be given by the investment company, and by the small-business firm, to the registration and prospectus provisions of the Securities Act. So also, an investment company, which would not otherwise be subject to it, might be brought within the ambit of the Investment Company Act. In any event, whether or not a public offering would be involved, this activity might result in an increase in beneficial owners beyond the 100 mark and thereby subject the company to that Act. In fact, even if no resale of the shares were effected by the small-business firms, the acquisition of stock by a substantial number of small-business firms might, unless the Commission should provide exemptive relief, have the same result.

A similar problem, but in reverse, arises when the investment company acquires the convertible debentures of the small- business firm and intends to dispose of the bonds as promptly as seasoning and the development of a market for such bonds permit, or to dispose of the underlying common stock received upon conversion of the bonds. Since most investment companies would be interested in turning over available resources as rapidly as possible

in order to continue their operations and to realize available gains, this activity of the investment company will be essentially that of an old-fashioned underwriter. It is, therefore, necessary to give consideration to the registration and prospectus provisions of the Securities Act and to the provisions of the Trust Indenture Act insofar as a subsequent disposition of these securities of the small-business companies may involve a public offering subject to these Acts. As noted earlier, however, the intrastate exemption provided by Section 3(a)(11), or the limited exemption afforded by Regulation A under Section 3(b), may be available. It would seem prudent, however, for the investment company and small-business firm to consider and to provide for the possible application of the securities acts in the event subsequent transactions fall within the scope of these Acts.

One final word as to the possible application of the Trust Indenture Act. Debentures not exceeding $250,000 in principal amount may be issued within any 12-month period otherwise than under an indenture. Debentures issued to a small-business investment company exceeding $250,000 in principal amount would normally be put out under a corporate indenture, it being implicit, as I have suggested, that such securities may eventually be distributed in a public offering which would require qualification of the indenture. In practice, however, since the Trust Indenture Act exempts from statutory qualification an indenture which limits the debt to be issued under it to not more than $1 million, it is doubtful that the qualification requirements of the Trust Indenture Act will be of great significance. In any event, Public Law 699 adds a new provision to the Trust Indenture Act--Section 304(e)--which authorizes the Commission to exempt, without limitation as to amount, any class of securities issued by a small-business investment company, subject to such terms and conditions as may be prescribed. The staff of the Commission is giving consideration to the need for, and possible extent of, an exemptive regulation under this authority.

These then appear to be the more important questions arising thus far which require consideration of the provisions of the Federal securities law and, presumably, of the relevant provisions of State securities law.

Now a suggestion as to procedure. Mr. McCallum will advise you how consideration by the Small Business Administration of preliminary applications for license may be initiated, and the circumstances under which a Notice to Proceed may be issued. I am informed that the Notice to Proceed will require evidence that registration under the securities acts is not necessary or, if it is, that compliance has been effected. In the interest of expedition, it is suggested that a copy of the preliminary application as finally amended before issuance of the Notice to Proceed, together with a copy of that Notice, be submitted promptly with any letter of inquiry to the Commission, if the assistance of the staff is sought to resolve any question you may have. Since at least two Divisions of the Commission's staff will have an interest in the matter, it is suggested that the request and other material be submitted in duplicate if this will not be burdensome. If you propose to file under any of the Acts, the application and the Notice to Proceed should also be made available in duplicate to assist our attorneys, examiners, and accountants in

reviewing the papers. At this point I wish to emphasize again that neither Form N-5 nor Regulation E is available prior to the time a Notice to Proceed has been issued by the Small Business Administration. We will be available, however, to answer any questions you may wish to present prior to that time. Finally, I wish to emphasize that the Commission is most anxious that its procedures and requirements be consistent with the statutory policy of Public Law 699 and that such accommodation to the needs of small business, as is not inconsistent with investor and public protection, be fully extended. Your comments and suggestions will be welcome.