# REMARKS OF

## RICHARD C. BREEDEN, CHAIRMAN
## U.S. SECURITIES AND EXCHANGE COMMISSION

**NATIONAL PRESS CLUB**
**WASHINGTON, D.C.**

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U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
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# FINANCING AMERICA'S GROWTH

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Ladies and Gentlemen. It is a very great pleasure for me to be with you this afternoon for my maiden voyage before the National Press Club. As such, this is a somewhat daunting occasion, as I have been used to the luxury of sitting where you are sitting, and waiting for the speaker to carry the ball. On the other hand, no matter how critical the audience, I am pleased that I have gotten this far. I understand that after my press conference last week on our new rules for executive compensation, an anonymous CEO called offering to cater the lunch -- for the head table only. What a time to be caught with your food taster on vacation and your kevlar vests at the cleaners.

When thinking about the missions of the SEC, the subject of investor protection is invariably the first thing that comes to mind. That is an appropriate reaction, for protection of the more than 40 million Americans who own securities directly -- more than 50 million if you count participants in stock mutual funds -- is unquestionably the first and foremost assignment of the SEC. Protecting investors against fraud and manipulation is a task that

is deeply ingrained in the traditions of the agency, and it is a mission that is every bit as important today as it was when the nation's federal securities laws were first enacted in the 1930s.

Indeed, since the percentage of the U.S. population (21%) that is investing in the equity securities markets and the value of their investments (more than $4 trillion at current values) have never been higher in our history, just perhaps we have been doing something right for the last 59 years. Indeed, with ownership of roughly 50% of the value of the equities of over 12,000 public companies in the hands of individual investors, the U.S. has by far the widest dispersion of ownership among the general public of its productive base of any developed country. That is a major asset for our economic future.

To be sure, there are a few academic theorists out there who believe that the development of modern techniques for hedging, and new financial instruments, have eliminated the need for the SEC. Of course that theory requires that you overlook newspaper accounts of BCCI, Robert Maxwell, Salomon Brothers, Nomuragate, Michael Milken and a few other situations that suggest that fraud and investor rip-offs may not have disappeared from human history. Indeed, this view is a bit like arguing that the development of high performance cars, for which I have a weakness, has eliminated the need for traffic cops, for whom I have infinite respect.

A second critical mission of the SEC is to promote market stability, and the integrity of the critical operating systems that today handle trades of hundreds of millions of shares -- and settlement of tens of billions of dollars of transactions -- worldwide everyday. These systems have to be efficient, reliable, and ready to absorb sudden and massive surges of trading volumes.

As important as these responsibilities for investor protection and market stability are, I would like to spend the remainder of my time today on our third critical assignment. That is, quite simply, overseeing the capital-raising activities of a securities market that last year provided approximately $700 billion in public and private offerings of all types to meet the financing needs of America's economy. Last year's financings in the securities market exceeded the largest total in our history by around 50%. In public offerings, every individual sector showed enormous gains such as:

- Equity securities --- UP 185%
- Convertible debt --- UP 56%
- Investment grade debt --- UP 84%

Several factors other than sheer volume were significant. One was that we saw a net formation of new equity in U.S. businesses for the first time since 1983, with an estimated total of around $35 billion. However, at last year's pace, it will be around the second quarter of the year 2007 before we replace the one-half

trillion dollars in equity that was retired during the years 1984-1990. Therefore, we need not a year, but a generation of equity building in the private sector. From my perspective, the three point plan for our national economic future ought to be:

1. Invest.
2. Invest.
3. Invest.

Numerous changes, including a tax system that does not consistently reward the issuance of debt and penalize the holding of equity investments, will be needed if we are to come anywhere near to the investment levels that will be needed.

Of all the sectors that require investment, the financing of America's small businesses is especially critical. Indeed, this challenge represents no less than the financing of our economic future.

The roughly 20 million small businesses in the U.S. economy employ more than half our labor force and produce about half our gross domestic product. Firms with less than 20 employees created 4,016,000 new jobs during 1988-1990, while firms with more than 20 employees lost 1,352,000 jobs during the same period. Small firms also accounted for a disproportionate share of new technology and productivity growth.

While the statistics tell one part of the story, if anything they significantly understate the importance of small businesses -- and particularly brand new startup companies -- in our economy. These small businesses keep our economy dynamic, provide new technologies, and indeed, create whole new industries.

Indeed, many of the new technologies that have revolutionized our lives have come from startup companies of individual entrepreneurs. For example, few among us today could imagine a world without convenient air transportation for people and goods, yet the entire aviation and air transport industries sprang from a bicycle shop run by two brothers in Dayton, Ohio.

Though the Wright Brothers have passed on, the spirit of Kitty Hawk is still to be found in tiny companies across this country. This speech was prepared on the omnipresent contribution of another pair of small business entrepreneurs -- the personal computer. Who knows where my kids would learn math if Steve Jobs and Steve Wozniak hadn't started Apple Computer by soldering circuit boards in their parents' garage, and if Wozniak hadn't been willing to sell his VW bus to help raise their initial seed capital.

The good news about financing small businesses is that the securities markets are providing very significant flows of equity capital. Last year more than $16 billion was raised in initial public offerings, a nearly three-fold increase over the $4.6

billion in 1990. Hawk Marine Power, Precision Optics, Candy's Tortilla Factory, Osteotech, Inc., Au Bon Pain, Laser Pacific Corp., Platinum Technology, Dianon Systems, Marvel Entertainment, and many, many others were able to offer their common stock to the public last year through IPOs.

The bad news about financing small businesses is that the number of startup businesses every year has fallen since 1986, with about 70,000 fewer new businesses formed in 1991 than in 1986. In addition, the number of companies that survive the challenge to grow large enough to be a candidate for a NASDAQ or AMEX listing may be in the process of shrinking still further. This is due to the impact of changes in financing opportunities at early stages of company growth.

Typically, a newly formed company begins operations using the savings of his or her founder, and often investments from parents, family and close friends or acquaintances. Once the resources of these early investors are exhausted, the startup firm must typically finance its growth through venture capital firms and commercial banks. Both of these sources of funds tend to be very expensive (reflecting the high risk of these enterprises), and bank financing has become increasingly difficult for small firms to obtain. Indeed, the disparity between the financing channels for small firms and those of large companies, with access to commercial paper funded by money market funds and other institutions, as well

as medium and long term securities of all types, has never been greater.

This situation is not one that should be ignored, as it represents a significant increase in the obstacles that face the very firms that have traditionally provided the greatest component of U.S. economic strength. Here regulatory costs due to non-financial programs like environmental laws can also have a very damaging impact on startup and small businesses. Though the SEC does not have the ability to address many aspects of the broader problem, there are a number of areas where I believe that it may be possible in the short term to reduce the costs and other barriers to access to capital markets for small firms without weakening the protection of investors.

## SEC's Small Business Initiative

The current process for registering securities that will be offered to the public is carefully designed to provide analysts and investors with the information that they need to make informed decisions concerning investment. Small companies often involve large risks, and investors must have the information that they need to evaluate risks carefully. If this information was not provided, liquidity for financings would most likely disappear. Similarly, if the information that is provided proved misleading and inaccurate, investor willingness to commit funds could well be

sharply diminished, and the cost of financing would inevitably rise. Certainly the lessons that we learned the hard way with respect to penny stock frauds cannot be ignored in any review of the overall system.

While any system must continue to provide a high quality of disclosure and vigorous antifraud efforts, there are many aspects of the current system that may add to the difficulty of raising capital without necessarily contributing to good disclosure. For example, under the current system, a company may have to spend $200,000 or more just to prepare the mandated disclosure forms and financial statements without knowing whether there would be any investor interest in the company. For a company whose shares are already trading in the public markets, the existence of a market for its shares is already established, thereby making the pre-offering expenses reasonably certain to be recoverable in an ultimate offering.

To improve this situation, I intend to propose that the Commission issue proposed rule changes that would significantly increase flexibility in structuring early stage securities transactions. Final action, of course, will depend on formal action by the Commission acting as a group, and each of our Commissioners will have to give careful consideration whether or not to support these ideas. Nonetheless, I believe they make sense. These steps would include:

- allowing issuers conducting an offering of "seed capital" securities under Rule 504 to issue up to $1 million dollars per year in unrestricted securities; and to broadly canvass the public for interest from investors.

- raising the annual ceiling for use of Regulation A, which is a limited public offering using a simplified disclosure document, from $1.5 to $5 million dollars per year. This would utilize existing statutory authority.

- allowing use of a simplified "Q&A" form for Reg. A offerings, and streamline existing procedures.

- allowing pre-offering publication of <u>factual</u> information about the company and its business prior to filing actual Reg. A disclosure documents; <u>provided</u> that any such material, which would be subject to antifraud requirements, is filed with the SEC simultaneously to its first use.

In addition to simplifying the Regulation A and Rule 504 offering processes, the SEC will propose to create new forms for the registration of securities by small companies, and for their ongoing disclosure requirements. At present, the SEC utilizes "Form S-18" for small offerings. This is a more simplified form

than the traditional S-1, but it is only available for an IPO of up to $7.5 million, or repeat offerings within the same year of the IPO.

Under the new system, the SEC will create a new form for small companies, rather than small offerings. This new "Form S-B" would be available for IPOs and repeat offerings by any company below a specified size, such as a market capitalization of $20 or $25 million. To go with the new streamlined offering document, the SEC will also propose to create a new "10-K Junior" and a "10-Q Junior" for the periodic disclosures of smaller companies. While these forms would still require the use of audited financial statements and disclosure of all material information, the complexity of the forms will be streamlined to reduce significantly the filing costs for smaller companies.

To accompany these proposed changes in the requirements of the 1933 and 1934 Acts, I believe that the SEC should also propose changes in the Investment Company Act of 1940 designed to make it easier for investment companies to invest in the securities of smaller companies, as well as to form specialized financing devices tailored to small business financing without registration as a mutual fund where this is not necessary to protect investors.

Among other things, I will suggest that the Commission should consider:

- raising the eligible volume of "illiquid" holdings of open-end mutual funds from 10% to 15%. This would enable significant new investments in U.S. small businesses, whose securities are by nature less liquid, without creating risks to the safety of funds choosing to utilize this flexibility.

- seeking public comment on allowing funds to be organized in a way that would, subject to full disclosure, allow "redemptions" at intervals less frequent than the daily requirement under current law. This would enable funds to be created with a much greater orientation to venture capital-style investments; and

- seeking public comment on raising the current limitations on funds that can be raised by Small Business Investment Companies and Business and Industrial Development Companies.

In addition to these rulemaking initiatives, the SEC should also consider proposing several legislative steps to Congress. One of the most important of these proposals would be to create a new class of venture capital fund that would be exempt from registration as a mutual fund so long as all its investors are highly sophisticated individuals or entities such as pension funds

or insurance companies.

Securitization

For the longer term, the SEC also needs to help those who are attempting to find ways to securitize the receivables of small businesses into debt securities that can be sold into a liquid secondary market. Here the objective is to develop an ability to pool the securities of smaller firms into larger packages that can be underwritten and purchased by large institutions and other purchasers. To be successful, techniques of standardizing documentation and credit underwriting that are now widely utilized in mortgage-backed and other asset-backed securities, with inevitable adaptions and modifications, will have to be utilized.

This would represent a big change from current practices. However, these problems have been faced -- and overcome -- before. Huge volumes of securitizations of mortgages; credit card receivables, auto loans, boat loans, aircraft leases and other assets prove that these hurdles can be overcome.

Indeed, though the first mortgage-backed securities were offered as early as the 1880s, the "modern" use of the mortgage-backed security did not arise until the first GNMA pools were issued in late 1970, barely 20 years ago. From a tiny beginning, that market has grown to include over $1.1 trillion in mortgage-backed securities outstanding, representing interests in over 40%

of all U.S. single family homes.

By seeking to adapt the techniques of securitization to small business loans -- especially short term debt instruments, we have an opportunity to facilitate a market that will improve the availability, and hopefully reduce the cost, of capital for small firms. Indeed, by giving banks the option to obtain liquidity from their small business loans, such a new market could help allow many banks to remain more active small business loan originators, with fewer capital and other constraints.

Adapting the techniques of securitization to small business instruments is a long term project. To help facilitate the process, however, I believe that the SEC should propose to expand the use of shelf registrations under Rule 415 for investment grade securities backed by non-mortgage assets. Necessary relief under the Investment Company Act should also be designed to help achieve a coordinated regulatory response to developments in the securitization field.

Conclusion

The steps that I have outlined today represent in some cases a significant new approach to the registration procedures in use today. For the long run we should seek to maintain investor protection and the quality of disclosure, while cutting costs, reducing barriers and improving flexibility. Certainly we will

weigh public comments carefully as we move forward, and I'll be working closely with my fellow Commissioners as we consider each of these ideas.

Less than one month ago, the President put forward a wide-ranging program of steps his Administration proposed to take to curtail unnecessary regulatory costs that can stifle economic growth. Indeed, regulatory costs often fall heaviest of all on the small firms least able to afford non-productive expenses. Several of the steps that I have outlined today were included in the President's message. Of course the ultimate decision on all of these proposals will rest with the full Commission, acting in its independent capacity. However, it is worth noting that lowering the cost of capital and seeking to facilitate financing for the small businesses of America is a challenge that is of great importance, and one that Republicans and Democrats, Legislative and Executive branches, should work together to meet.

In a very real sense, the small companies of today represent the gnp of the year 2000. Without the innovation and energy of newly formed companies, our economic future will indeed be different than we might wish. By mobilizing our talents to make sure that new companies have a chance to obtain the capital that is essential to fueling their development, we will be taking critically important steps to build a strong and prosperous economic future. Thank you.