PROMOTING SMALL BUSINESS CAPITAL FORMATION: THE ROLE OF THE SEC

REMARKS OF
COMMISSIONER MARY L. SCHAPIRO*
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

BEFORE THE
INTER-AMERICAN INVESTMENT CORPORATION'S
CAPITAL MARKETS ROUNDTABLE

WASHINGTON, D.C.

NOVEMBER 13, 1992

*The views expressed herein are those of Commissioner Schapiro and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I. Introduction

Good afternoon. I'm really delighted to be able to speak to such a distinguished group of colleagues and friends - distinguished not only because of all your individual achievements, which are many, but because of your commitment to ensuring the growth and vitality of the Latin American capital markets. As many of you know, your markets - individually and collectively - captured my interest several years ago and now have a hold on my heart as well as my mind. I have said this many times, but it is worth saying again: I firmly believe that the securities markets of Latin America and the Caribbean have an unlimited potential for growth, and for assuming leadership roles in the international arena. The election two weeks ago in London of Luis Miguel Moreno, the Chairman of the CNV in Mexico, as the Chairman of the Executive Committee of the International Organization of Securities Commissions, as well as the election of Martin Redrado of the CNV in Argentina as Chairman of the Development Committee foretell such leadership by Latin America in international markets.

This afternoon I am going to speak about the SEC's efforts in the past year to broaden and facilitate the access of small businesses to the capital markets in the United States.

I want to begin by quoting from an article that appeared last week in the New York Times.[1/] The article discussed the difficult experiences U.S. entrepreneurs have had in the past several years, trying to raise money to fund their enterprises. One individual profiled in the article -- a Mr. Babson -- was struggling to get a computer software company up and running. He said, in describing his two-person company, "We are small, but there's going to be more and more start-up companies like this. That's where the growth comes from."

Mr. Babson's sentiment exactly matches my own. While we use the term "small business" to describe enterprises that may be operated out of someone's home, the fact of the matter is that small business in the United States is anything but small when measured in terms of its importance to the health of the U.S. economy. The statistics are enlightening: there are approximately twenty million

---

1/ See "Signs of Thaw for Small Business," New York Times D1, November 4, 1992.

small businesses in the United States, employing more than half of the domestic labor force, and producing nearly half of the gross domestic product. Small businesses account for two-thirds of all new jobs created in the U.S. Indeed, firms with less than 500 employees employed over 57 million people in 1990, almost half of total civilian, nonagricultural employment.

Beyond the statistics, small businesses are important because they often produce new technology and innovations - like computers, robotics, and pharmaceuticals - that enable us to make strides in our standard of living, as well as compete in a global economy that rewards new ideas with new jobs. For all of these reasons, historically, U.S. federal policy makers have been committed to ensuring the vitality of small business. I believe that the new administration in Washington is unlikely to depart from this path, and will in fact place a great deal of emphasis on ways to foster the growth of small and medium size companies. Perhaps evidence of this is the rally we have seen in the NASDAQ market since the election.

As you might expect, small businesses have been among the casualties of the economic recession in the U.S. and globally. These

conditions have had a markedly negative impact on the ability of U.S. entrepreneurs to convert their ideas and dreams into products, manufacturing plants, and marketing teams -- in other words, into the creation of a small business. Similarly, businesses that are already going concerns but are still in the development stage have encountered great difficulty when they try to expand their operations by raising money in either the public or private markets. Again, the statistics are revealing. If you look at the number of equity IPOs from 1986 to 1991, what you see is a prolonged period of contraction, followed by a mild recovery in 1991. In 1991, initial public offerings of equity amounted to $16 billion, a four-fold increase over 1990 levels. That's the good news. The not-so-good news is that this bounce-back in the public markets has not carried over to private sector financing. Total private equity financing decreased from $17.7 billion in 1986 to $6.4 billion in 1991. And, as you may know, commercial lending by U.S. banks declined precipitously between 1989 and 1991, as the banks fled to the relative safety of investing in U.S. government securities rather than U.S. businesses or real estate. While there are many debates in the United States about the causes of our "credit crunch," no one doubts its impact on small and medium sized companies.

The Commission doesn't have much leeway when it comes to trying to change the lending practices of banks or venture capitalists, but we can do something to ensure that the costs our regulations impose are not in fact roadblocks to small business development. So the Commission this year undertook a reexamination of the regulations that govern how money is raised by small business issuers. We had two goals: one, to rewrite our regulations in a manner that would liberalize access to the public market for start-up and developing companies and; two, to lower the costs for small businesses that desire to have their securities traded in the public market. The trick in trying to achieve these goals is to make sure that the investor protection emphasis in our laws was not sacrificed in a well-intentioned, but poorly executed, compromise. And so as we went about exploring the best way to achieve these goals, we were keenly aware that any changes we made to our regulatory scheme had to provide, first and foremost, for the safety of U.S. investors. Accordingly, regardless of the changes we made, the antifraud provisions of our securities laws remain in full force and effect.

II. Revisions to Regulation A

The first step we took, in March of this year, was to propose significant revisions to our Regulation A. Since its enactment in 1981,

Regulation A has provided an exemption from registration under the Securities Act of 1933 for issuers trying to raise a relatively small amount of money - $1.5 million was the maximum allowed in any one year. Issuers electing to use Reg. A had to submit an offering statement to the Commission at least ten days prior to the date on which the initial offering or sale was made, and they had to deliver an "offering circular" (containing disclosure information about the issuer) to virtually all prospective investors. They did not, however, need to file audited financial statements, nor did the use of Reg. A result in a continuous reporting obligation under the Exchange Act. These less stringent requirements should have made Reg. A an attractive financing vehicle, but they did not. Reg. A financings decreased from a total of $408 million in fiscal year 1981, to only $34 million in calendar year 1991.

When we asked ourselves why Reg A had become so unpopular, we identified two principle problems. First, the amount of money that could be raised seemed too low in view of historical inflation rates. Second, the prohibition on pre-offering communication with prospective investors seemed to adversely effect start-up companies. Businesses with an established secondary market know that there is investor interest in their securities, but start-up

companies have little means, if any, to gauge whether there is sufficient investor interest in their product to warrant the cost of undertaking a public offering. The cost of compliance has become quite high in the United States, sometimes running into the tens of thousands of dollars to hire a team of attorneys and accountants. Obviously, these costs are prohibitive for many individuals trying to sell a new idea. So the Commission suggested a new approach for dealing with pre-offering communication, and proposed raising the dollar limit on the amount of the offering from $1.5 million to $5 million. I would like to discuss in some detail the new pre-offering communication rules because this may turn out to be the most significant change the Commission made for small businesses.

The approach we adopted to allow for pre-offering communication is a concept we call "testing the waters." It reflects our conclusion that developing companies need to be able to gauge the likely depth of investor interest in their securities BEFORE expending significant amounts of money to comply with SEC disclosure requirements. Pursuant to the testing the waters provision, an issuer is permitted to solicit indications of interest prior to preparing and filing with the Commission the full-blown, mandated offering statement. Issuers may communicate with prospective

investors via either written or oral statements describing the issuer and its business. Apart from the identification of the chief executive officer and a brief discussion of the issuer's business, the Commission has not mandated the substantive contents of the statement (in other words, we permit "free writing"), but the statement must be limited to a factual presentation. The more noteworthy provisions of the testing the waters rule are as follows:

• Issuers may publish their statement in a newspaper or magazine, and they may also broadcast a solicitation on radio or television. No solicitations are permitted however until the testing the waters document is submitted to the Commission.

• The issuer is not permitted to accept any money in response to the testing the waters material, nor is the issuer allowed to accept a commitment to buy. In fact, the material must include a statement that no commitments can be made, and that an offering circular will be delivered to the purchaser prior to the consummation of any sale.

• An issuer can attach a coupon to the written material, that investors can return to the company advising it of their interest. I

have even seen coupons that ask prospective investors to indicate how much they would be willing to invest.

• Finally, once an issuer files its offering statement with the Commission, it must stop using its testing the waters solicitation material, and no sale of securities may occur until twenty days after the last use of the document.

In other amendments to Reg. A, the Commission changed the timing requirements for an offering, so that now, an offer can be made as soon as the offering statement is filed with the Commission, and sales can be made twenty days after that filing. And, in an effort to ease concerns among issuers that an unintended misstep on their part would result in loss of the registration exemption, the Commission added a rule that protects issuers who have made a substantial and good faith effort to comply with the requirements of Reg. A.

It seems to me that the innovations we are trying in the Reg. A area -- particularly the testing the waters concept -- strike the right balance between cost to the issuer and benefits to the investor. We have given up nothing on the disclosure side, while at the same time

permitting issuers to explore the possible market for their securities prior to incurring substantial expenses. The Commission, too, will have an opportunity to acquaint itself with the issuer, and correct any misimpressions the issuer may be creating, before the issuer ever goes to market with its offering.

I should also note that in an effort to assist the smallest companies with capital raising, the Commission recently made it possible for certain issuers to raise up to $1 million in a 12-month period, without having to comply with any federal securities laws, other than the antifraud and civil liability provisions. These amendments to our Rule 504 will permit, for the first time, general solicitation, and the unrestricted resale of securities sold pursuant to this exemption.

III. Integrated Registration and Reporting for Small Business Issuers

I'd like to mention another proposal that the Commission recently adopted in an effort to scale down the costs of complying with our registration and reporting requirements. At the same time that the Commission proposed revisions to Reg. A, it also undertook the development of an integrated disclosure system for small businesses - a system that would allow small businesses to comply

with the registration and reporting requirements of both the 1933 and 1934 Acts, by referring to the requirements of one regulation. What we adopted, this past summer, is something called "Regulation S-B." Regulation S-B will enable small business issuers to register any size offering of securities, on a simplified registration form. For purposes of the rule, a small business issuer is defined as one having revenues less than $25 million, and a market value for its publically held securities of less than $25 million. Based on this criteria, the Commission estimates that 35% of all U.S. public companies will be eligible to use the new simplified disclosure system.

Briefly, Regulation S-B offers at least three advantages over the Commission's other disclosure rules. First, in the area of financial reporting, which has always been one of the most costly aspects of complying with the Commission's regulatory scheme, Regulation S-B permits the filing of less detailed financial statements than were formerly required. Second, many issuers using Reg. S-B will be allowed to provide a less expansive discussion of their company's business plans and prospects. Third, the Commission made a concerted effort to simplify the language of the forms, so that issuers might not, in fact, need to hire an entire team of attorneys to interpret the form. Each of these measures was designed to reduce the cost

of compliance, while at the same time preserving the fundamental investor protection goals of our statutes.

IV. Other Initiatives

I think it is important to understand that while these changes seem modest, they are very real changes from the prior regulatory framework. It will be at least a year before we are able to gauge whether these and all the other changes we have made are having their intended impact. In the coming year, the staff will be looking closely at the number of Reg. A offerings and at the use of the testing the waters provision. We will want to see if this provision does in fact lead to an increased number of offerings, and whether the solicitation documents prepared for the purpose of gauging potential investor interest, do not in fact mislead investors or confuse them. We will also be working on further refinements to our registration and disclosure systems, with the goal of creating a new transitional system that would permit certain small business issuers to use the streamlined disclosure format of an exempt offering, to meet the continuous reporting obligations of the 1933 and 1934 Acts.[2/]

[2/] See Release Nos. 33-6950, 34-30969, and 39-2288 (July 30, 1992) for a discussion of additional proposed revisions to facilitate financings by small business issuers.

Importantly, in recognition of the vital role mutual funds play in establishing deep and liquid markets, the Commission will turn its attention to adopting rules to permit investment companies to invest a greater percentage of their assets in less liquid securities - which of course includes the securities of most small businesses. We have already raised the limit on mutual fund investments in illiquid assets from 10% to 15%. As a next step, we would like to authorize the creation of several types of hybrid mutual funds - somewhere between open-end and closed-end funds, that would have greater flexibility to invest in less liquid securities because of periodic redemption features and extended payment periods.[3/] We plan to explore other ideas in the mutual fund area, to encourage their investment in venture capital and small business securities, and privately placed or restricted securities.

There are other legislative and regulatory measures that we would like to adopt in order to broaden access to our capital markets by small business.[4/] One initiative that requires action by the U.S. Congress is to raise the ceiling on the maximum amount of money

---

3/ See Release Nos. 33-6948, 34-30967, IC-18869, File No. S7-27-92 (July 28, 1992).

4/ See the Commission's proposed Small Business Incentive Act of 1992, H.R. 4938, S. 2518, 102d Cong., 2d Sess. (April 9 and April 2, 1992).

that can be raised in an exempt offering, from the current limit of $5 million to $10 million. Another initiative that interests me is the idea of securitizing small business debt, in the same way that many other types of debt, such as home mortgages, are bundled together and packaged for sale. The home mortgage market was truly revolutionalized by securitization. In a little more than twenty years, we have gone from no securitized home mortgages to over $1.2 trillion worth of home mortgage securities outstanding in 1992. Securitization of small business debt could have a significant and similar impact on the willingness of traditional lenders to make funds available to small businesses, without the constraints of capital requirements. This would also create a new instrument for investors willing to invest in the pooled debt of many small businesses. I don't want to suggest the creation of yet another government sponsored finance corporation, but I believe that the Commission should work towards the removal of regulatory impediments to securitization.[5/]

5/ Last month the Commission adopted regulations that extend the benefits of shelf registration now available to mortgage-backed securities to all structured financing transactions, including small business loans. See Release Nos. 33-6964, 34-31345 (October 22, 1992).

V. Conclusion

While I can't predict what the priorities of a new administration will be, I do believe that the Commission will continue to press for the enactment of measures designed to carve out a special niche in our regulatory system for small and start-up companies. Small businesses have shown themselves to be the backbone of the U.S. economy. Maintaining their vitality in the coming years must be one of our highest priorities.

Thank you.