MIDWEST REGIONAL ASSOCIATION

SMALL BUSINESS INVESTMENT COMPANIES

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PROTECTION OR OPPRESSION?

THE INVESTMENT COMPANY ACT IMPACT ON THE PUBLICLY HELD SBIC

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At the outset may I emphasize two fundamentals which may not always be apparent to those of you who have had occasion to confer with our staff and have become the recipient of interpretations lacking in palatability. The first is that I know of no one within the Commission who does not applaud the wisdom of the Congressional policy of encouraging small business so well expressed in Section 102 of the Small Business Investment Act of 1958. Second, we are aware that a small business investment company is a different creature than a mutual fund or the conventional closed-end investment company and that it has unique problems which often merit some special treatment.

Nevertheless, a small business investment company is in fact an investment company, and its structure falls clearly within the appropriate definitions of the Investment Company Act of 1940. When its securities are beneficially owned by more than 100 persons or when it makes a public offering of its securities, 1940 Act jurisdiction vests and another Congressional policy springs into play. That policy -- investor protection -- neither excludes nor has it been superseded by the policy of encouraging small business which is the raison d'être of the Small Business Investment Act. Though not inconsistent in concept, concurrent application of the two policies involves differing considerations which are not always totally reconcilable.

What all this leads up to is that we have a responsibility for investor protection. We also recognize the Congressional intent of encouragement of small business enterprises. We must, therefore, adjust our thinking to the extent conscience will permit to accommodate both policies. This involves a rather high degree of flexibility and willingness to do that most difficult task of all -- imaginative but realistic thinking.

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How well have we done that job? "Not very," some of you would assert. Indeed, I hear rumblings that we are "killing the small business investment program" and that our investor protection motivation has become in fact a rather odious oppression of what you gentlemen are trying valiantly to accomplish. I readily plead guilty to non-perfect performance. On the other hand, I deny any element of callous disregard of your problems. For a fair appraisal may we, therefore, examine some of the more common troublesome areas to measure our desire to be helpful.

I. Transactions Between Affiliates Section 17 of the Investment Company Act

Section 17 is perhaps the most important protective provision in the Investment Company Act. In substance and with certain exceptions it prohibits any affiliated person, promoter of or principal underwriter for a registered investment company, or any affiliated person of such person, from selling any security or other property to or borrowing any money or purchasing any security or other property from the registered investment company or any company controlled by the registered company without first obtaining an order from the Commission exempting the transaction from the Section. Before issuing such an order the Commission must find expressly that the terms of the transaction, including the consideration to be paid or received, are reasonable and fair, do not involve overreaching on the part of any person concerned and that the proposed transaction is consistent with the policy of each registered company concerned and with the general purposes of the Act.

There are a number of other restrictions within Section 17. Of particular relevance to SBIC operations is Section 17(d) and Rule 17d-1 which bar similarly affiliated persons from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement in which any registered investment company or any company it controls is a participant unless the Commission authorizes the transaction by order. In determining whether to issue the order the Commission must consider whether participation in the joint enterprise by the registered or controlled company is consistent with the policies and purposes of the Act and the extent to which such participation is different from or less advantageous than that of other affiliated participants.

Section 17 did not appear in the Act by accident. The Commission's study of Investment Trusts and Investment Companies which led to the adoption of the 1940 Act is rife with documented cases of abusive transactions between affiliates and their investment companies. Section 17 was not drafted because abuse might occur. It was created because abuse had occurred and with frequence.

At a recent meeting of persons interested in the Small Business Investment Act, sponsored by the Administrator of the Small Business Administration one SBIC speaker complained that federal regulation seemed to proceed on the premise that nearly all in the industry are dishonest. I make no such charge. Indeed, I am willing to accept the converse assumption that nearly all in the SBIC industry are scrupulously honest. Nevertheless we would be remiss if we ignored the existence of human frailty. We cannot legislate honor, but we can enact standards which may chill temptation and provide a remedy against those who succumb.

This is not to suggest that we must be doctrinaire in our application of Section 17 or any other provision of the Investment Company Act. We do have rule making exemptive power, and presumably Congress conferred the power in the expectation that it would be used with a degree of enlightenment to relieve hardship and special situation cases where any impairment of the public interest would be remote. We have provided rule making relief for SBICs in several areas, and we are now proposing to liberalize Rule 17a-6 by extending its exemptive coverage to a broader range of transactions between affiliates. The proposed amended rule was noticed for public comment on September 27, 1963. The return date for comments is this October 31st.

A prime consideration for proposing the rule was our recognition that the unique relationship of an SBIC and the small business concern it finances often results in affiliation within the meaning of the 1940 Act because of ownership of voting securities or because of the power of the SBIC to control the small business concern through, among other things, ownership of convertible securities or loan agreement protective covenants. The scope of the term "control" in the Investment Company Act is much broader than conventional dictionary definitions. It is not limited to majority ownership of equity securities or to control for the purpose of controlling. For 1940 Act purposes control often exists where the sole purpose of the lender has been to provide a measure of protection for his investment. The proposed rule will go far to alleviate burdens resulting from control status in the SBIC context.

Among the transactions that the amended rule would exempt is the conversion by a registered company of securities issued by an affiliated company. The act of conversion constitutes the purchase by the small business concern of a security from its affiliated SBIC, namely the security surrendered upon the conversion, and this falls within the prohibition of Section 17(a)(2). Existing Rule 17a-6 does not exempt the transaction because it applies only to paragraphs (1) and (3) of Section 17 and not to paragraph (2). Subject to the qualifications described below, the amended rule would afford an automatic exemption, if adopted.

It has come as a surprise to many SBICs to learn that some mergers of controlled and affiliated small business concerns could not be effected without a permissive order of the Commission. This is because the merger can involve the sale or purchase of property by an affiliated company to a controlled company which contravenes Section 17(a)(1). It can also involve the sale of securities by an affiliated company or an affiliated person thereof to the controlled company, in violation of Section 17(a)(1).

Industry representatives were vehement in the view that the protective cure of a Section 17(b) order could kill the patient. They pointed out that many mergers of this nature are born of necessity and the need for speed in consummation is urgent. The time involved in preparing, filing and processing a Section 17(b) application for an exemption could seriously prejudice the hoped for result of the merger. We recognized the merit of this position, and adoption of the amended rule would provide relief. Other relief would be provided by adoption of the amended rule, including automatic exemptions from Section 17(a) for recapitalizations of affiliated companies and material revisions of securities issued by affiliated companies.

We were willing to recommend adoption of the rule because the transactions proposed to be exempted contained little likelihood of overreaching of either the registered company or an affiliated or controlled publicly held small business concern. To provide a measure of assurance on this score, the proposed rule contains certain conditions. For example, no automatic exemption will flow from the rule if the outstanding securities of any party to the transaction, other than the registered company, are held by more than 100 persons nor if any officer, director or other affiliate of the registered company has any direct or indirect financial interest in the affiliated or controlled company. "Financial interest" is defined to exclude, among other things, usual directors' fees and any interest arising through ownership of securities of the registered company.

We do not suggest that proposed Rule 17a-6 provides your industry with a panacea. We do believe it will be a substantial help. And our minds are not closed to possible revisions. We are confident that those of you subject to our jurisdiction will study the proposed rule carefully, and we will welcome your comments.

As to joint enterprises falling within Section 17(d) and Rule 17d-1, relief in a limited area was provided for bank affiliated SBICs in 1961 by the addition of sub-paragraph (3) to paragraph (d) of Rule 17d-1. In essence this excepted from the Rule joint loans, advances of credit to and acquisitions of securities or other property from a small business concern by an SBIC and its affiliated bank.

Beyond this we have not gone. We do have the entire 17(d) area under study, but we have no definitive proposals under consideration other than one which would provide an automatic exemption for joint transactions where second tier affiliated persons participate which would appear to involve clear arms length bargaining. Otherwise our study is not for the purpose of developing exemptions for SBICs or others but rather for the purpose of clarifying what constitutes a "joint enterprise" and establishing meaningful guidelines. We are quick to acknowledge that Rule 17d-1 is not a model of clarity and that there is an unfortunate degree of confusion in the entire 17(d) area.

I regard Section 17(d) a vital safeguard. Joint investments between a director and his registered company create a climate conducive to abuse and can place the director in an impossible conflict of interest position. Illustrative of the danger are transactions we alleged in our recent injunction action against Midwest Technical Development Corporation and certain of its directors and officers. Midwest is not an SBIC though its investment operations were comparable to those of SBICs. While the Court was not as concerned as I about the seriousness of the joint investments involved in that case, it did confirm the correctness of our interpretation of Section 17(d) and Rule 17d-1 and found that 72 investments by a total of 11 directors and officers in 9 portfolio company securities violated Section 17(d).

Except to the extent mentioned, I hold out no hope to you for future automatic exemptive rule relief for SBICs or any other types of investment companies on Section 17(d) prohibited transactions. I do hold out the hope for clarification and the establishment of ground rules which will enable you to know where you stand with more precision.

II. Incentives
Sections 18(d), 23(a) and 23(b) of the Investment Company Act

A particular thorn in the side of the small business investment company industry is the Investment Company Act prohibition against the issuance of stock options. Section 18(d) of the Act specifically prohibits long term options or warrants, Section 23(a) bars the issuance of investment company securities for services, and Section 23(b) prohibits a registered closed-end company from selling its common stock at a price below its then net asset value. In aggregate these provisions effectively remove the availability of the stock option incentive to SBICs.

As to closed-end investment companies generally this was done deliberately. As Chairman Cary observed in testimony before a subcommittee of the House Committee on Banking and Currency on August 2, 1961:

> "The dangers inherent in the use of option warrants in the investment company context were made abundantly clear by the Commission's investment trust study which formed the basis for the statute. Indeed, the investment company industry itself recognized the need for prohibition against options in the statute which was enacted with its endorsement."

Would the Commission be justified in singling out small business investment companies for favored treatment by adopting an exemptive rule permitting SBIC stock options. I think not. I have no doubt that the stock option is an effective inducement for attracting key personnel. Indeed, were options offered to me my acceptance would not be delayed by soul searching. However, it does seem to me that there is a respectable controversy as to the social and economic desirability of the stock option in its typical present structure. I doubt if many can assert with complete candor that Henry Ford II is entirely right and that Dean Griswold is entirely wrong. Add this to the history of abuse of the option device by investment companies prior to the adoption of the 1940 Act and consider it in the context of the findings which the Commission is required to make to order an exemption.

The general exemptive provision, Section 6(c) of the Investment Company Act, requires the Commission to find that the proposed exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of" the Act. Among the policies of the Act specifically set forth is Section 1(b) which provides, among other things, that ". . . it is hereby declared that the national public interest and the interest of investors are adversely affected --"

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> "(2) when investment companies are organized, operated, managed . . . in the interest of directors, officers . . . rather than in the interest of . . . such companies' security holders;".

While the argument can be made that a modest grant of options is in the interest of investors and that their grant would not constitute operating an investment company in the interest of its officers, it is not so free from doubt as to justify the definitive findings which

the Commission must make, particularly in view of an unequivocal statutory prohibition. In my opinion your battle for stock options must be won, if at all, in the Congress and not in the Commission.

III. Valuation Disclosure
Section 30(d)(2) of the Investment Company Act

Small business investment companies in the performance of their venture capital banking functions will inevitably make a number of high risk investments if they are to carry out the purpose of the Small Business Investment Act. Just as inevitably some of the high risk investments will collapse. I doubt if anyone entering the program was not fully aware of this unhappy fact of life. But what many failed to realize, so we are told, was the full implication of Section 30(d)(2) of the Investment Company Act which in substance requires those SBICs subject to our jurisdiction to disclose to their stockholders the particular investments which had unfortunate, if not disastrous, results. When our interpretation of Section 30(d)(2) became known more than a little hue and cry was raised, and some went so far as to forecast forebodingly that we were sounding the death knell for many small business concerns and seriously impairing the SBIC program.

Section 30(d) requires a registered investment company to transmit periodic reports to its stockholders, including, among other things,

> "a list showing the amounts and values of securities owned on the date of such balance sheet;". (Emphasis added.)

To us this means that proper accounting treatment requires each investment to be shown at the valuation determined by the board of directors. To be fully informative both cost and value should be shown. Where specific investments are believed to be worthless or substantially diminished in value, a general reserve for losses is not sufficient.

Here the fracas began in earnest with officials of the Small Business Administration vigorously joining industry representatives in opposition to our position. We were told that this type of disclosure would be extremely detrimental to the small business concern; it would destroy their other sources of credit and place their competitors at an advantage in knowing their financial condition; small business concerns would avoid SBIC financing rather than risk public disclosure of their financial straights, and this would dry up the small business investment program.

To this I would give at least two answers. First, there has been to date no persuasive proof of the validity of any of the dire predictions. If a showing of actual or genuinely potential harm is

made, we will of course carefully reconsider our position. In this connection I cannot refrain from observing that during the negotiations conducted during 1959 and 1960 as to the content of our Form N-5R it was strongly asserted that the mere naming of small business concerns in whom investments had been made would be harmful. The reason given was that if it becomes known that a small business concern had obtained financing from an SBIC it would be interpreted that its credit standing was weak and this factor might be used to its disadvantage by creditors, competitors and others. While we were somewhat skeptical we did provide in General Instruction E of Form N-5R for omission from public disclosure of small business concerns financed by SBICs if certain justifications could be shown. General Instruction E has been utilized only rarely, and now after more than three years of the type of disclosure complained of we are not aware of any harmful results from public disclosure of the names of SBIC financed small business concerns.

Second, I revert to the Congressional mandate we must observe. Our purpose is the protection of investors. We believe that the SBIC stockholder, like the stockholder of any other investment company, is entitled to know specifically those investments made by the managers to whom he has entrusted his funds which appear to be unfortunate or unsound. We believe this information -- as well as information on spectacular successes -- is vital to enable him to evaluate the performance of his directors and his management. This is not to say that we will not temper our views if a genuine showing of harm is made. If you wish relief in this area, we await your demonstrating the need.

IV. Insider Trading Liability Section 30(f) of the Investment Company Act

The Investment Company Act is not without snares into which even experienced securities lawyers can fall in total innocence. One aspect of Section 30(f) is such a pitfall.

Section 30(f) was borrowed from Section 16(b) of the Securities Exchange Act of 1934 and imposes absolute liability upon certain insiders for any profits made in any combination of sales and purchase or purchases and sales of their companies' securities within a six months period. This short swing profit liability provision is well known to the bar and executives of publicly held corporations. Indeed, according to Professor Loss it has earned the unenviable status of being ". . . the most cordially disliked provision in all these statutes from the point of view of those whom it affects . . ."

Section 16(b) of the Exchange Act is applicable to short swing profits of insiders on securities of listed companies only. Section 30(f) of the 1940 Act is not so limited. It applies to securities of any registered closed-end investment company whether or not listed on an exchange. Presumably directors of SBICs are aware of this. In at least one case, however, the directors of an SBIC did not foresee the full impact of Section 30(f). In that case an SBIC director was a partner in an investment banking firm which was the lead underwriter in the public offering of the SBIC shares and which made a market in the shares upon completion of the offering. This meant that the director was liable at least for his pro rata share of his investment banking firm's short swing profits earned in the course of the market maintenance operations. The SBIC has applied for exemptive relief, hearings, briefing and oral argument have been completed, and the matter is sub judice before the Commission.

We recognize the quandary this result poses for an SBIC. An SBIC naturally wants a market maintenance operation to preserve some semblance of price stability and to avoid extreme price fluctuations in its stock. It also wants the expertise of an investment banker available on its board of directors. From the point of view of the banker, he may be unwilling to have his firm make a market in the company's stock unless he is on the board where he can keep in close contact with its operations. Yet he will not serve if he is to be subjected to almost certain liability.

Without presuming to forecast what the Commission's decision will be in the case before it, I can say that overall relief for SBIC market makers is at least in sight. Section 8(b) of the proposed Securities Acts Amendments of 1963 which has passed the Senate and awaits hearings in the House would exempt from the profit recovery provisions of Sections 16(b) of the Exchange Act and 30(f) of the 1940 Act transactions by a dealer which are part of his ordinary trading activities in an SBIC's securities and incident to the establishment or maintenance of a primary or secondary market for those securities.

V. Dual Federal Regulation

I am not too far removed from the private practice of law to fail to understand those who approach any form of federal regulation with something less than enthusiasm. And I have sympathy for those who find themselves regulated by not one -- but in part by two -- federal agencies differing in structure and not always consistent in operations and outlook. Clearly this is to be avoided if public interest permits. In the case of the SBIC will the public interest be served by transferring those functions we now perform to the Small Business Administration?

Without expressing an unalterable view at this juncture, I tend to feel that the dual regulation complaints have been exaggerated. And may I suggest this for your consideration. The SBA is in a real sense a promotional organization -- and properly so. It has been directed by Congress to do its best to foster small business, and in my opinion they have and are carrying out their Congressional directive admirably.

The Securities and Exchange Commission was not created to promote small business. Our mandate is to protect investors. All measures in connection with the encouragement of small business are not consistent with the protection of the investor in securities issued by an SBIC. A good case can be made that in each of the four instances I have previously discussed complete freedom from restriction would best encourage small business. But surely few of you would assert that such complete freedom would be in the best interests of investors. Is it wise, therefore, to combine in a single agency the administration of policies which can sharply conflict? You will recall that prior to passage of the Small Business Investment Act of 1958 a determined effort was made to shield SBICs from SEC jurisdiction. Congress refused, and I believe it is fair to say that it was a conscious determination at the time by a Congress which had been fully exposed to all phases of persuasion.

Conclusion

While investor protection is our responsibility, the SEC exists to help -- not to hinder or oppress. If the time ever comes when our minds are closed to your responsible and thoughtful proposals, our public usefulness will be at an end. We do not confer upon ourselves high marks for enlightened progress in your or any other area. But we are and have been making the effort.

And may I make a suggestion to you. Many times we learn of your problems with our legislation only indirectly. Complaints are often made to your national association or to the SBA or others, but not to us. If you are suffering hardship from our activities, tell us directly. You will find our doors open. You will find our staff willing to listen. I hope you find in these last remarks what is intended to be found -- namely, a cordial invitation to see us freely.