

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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SECURITIES & EXCHANGE COMMISSION

In the Matter of
THE NATIONAL ASSOCIATION OF SMALL
BUSINESS INVESTMENT COMPANIES,
ET AL.

537 Washington Building
Washington, D. C. 20005

(812-2297)

Investment Company Act of 1940

INITIAL DECISION

Sidney Ullman
Hearing Examiner

Washington, D. C.
November 4, 1969

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APPEARANCES: Charles M. Noone, for The National Association
of Small Business Investment Companies and
for individual small business investment
companies appearing as parties.

William T. Genetti, Eric W. Weinmann,
Jerome Garfinkel and John J. Sharp,
for The Small Business Administration.

Sydney H. Mendelsohn, David M. Butowsky,
Herbert E. Milstein, Raymond J. Klapinsky
and Paul R. Huard, for the Division of
Corporate Regulation.

BEFORE: Sidney Ullman, Hearing Examiner

NATURE OF THE PROCEEDINGS.

These proceedings were instituted by an order of the Commission dated January 14, 1969 ("Order"), issued pursuant to Section 40(a) of the Investment Company Act of 1940 ("1940 Act"), which directed that a hearing commence on February 19, 1969, on an application filed by The National Association of Small Business Investment Companies ("Applicant") on behalf of member companies. (Investment Company Act Release No. 5581). Applicant is a trade association with an active membership of 230 small business investment companies ("SBICs") licensed by the Small Business Administration ("SBA") pursuant to the Small Business Investment Act of 1958, as amended ("SBI Act"). Of the 230 active members, 29 are public companies which have registered with the Commission under the 1940 Act as management, closed-end, non-diversified investment companies. ^{1/}

The application was filed on March 15, 1968, pursuant to Section 6(c) of the 1940 Act, which reads as follows:

"The Commission . . . may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title . . . if and to the extent that such 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 this title."

Thereafter, informal conferences were held by counsel for the Applicant and counsel for the Division of Corporate Regulation ("Division")

^{1/} The application states: "While the 230 SBICs belonging to NASBIC represent only half of the 462 SBICs whose licenses remain outstanding it is estimated that the licenses of NASBIC member companies account for 80% of the assets currently committed to the SBIC program."

with the view toward narrowing the issues in the proceedings and discussing the possibility of reaching a settlement. As amended at the hearing and as treated in the post-hearing documents of the parties, the application seeks a Commission order exempting those SBICs which are subject to registration under the '40 Act from virtually all provisions of that Act.^{2/} Applicant's position is that the exemptions can be conditional, as discussed below, and that as a practical matter Commission oversight for the protection of investors can continue. Joining in the application and urging that it be granted are 24 SBICs which are members of the Applicant. They have been made parties to these proceedings. Also a party is the Small Business Administration ("SBA"), which participated actively throughout the proceedings and supports the application, urging that it be granted unconditionally.

Exemption is not sought by Applicant from Sections 8 and 24 of the '40 Act, which pertain to the registration of **investment** companies with the Commission.^{3/} Continuation of such registration is desired in order to accommodate SBICs electing to be taxed as regulated investment companies under Section 851 of the Internal Revenue Code of 1954.

^{2/} As filed, the application requested exemption of the SBICs from those provisions of the '40 Act allegedly not applicable or "not of regulatory importance" to SBICs; from other sections which, if deemed necessary, could be incorporated in suitable Small Business Administration regulations; and as to other sections it requested either Commission exemption, adoption of a new Rule, or delegation to the Small Business Administration of authority to regulate SBICs. As indicated in the text, infra, during the course of the proceedings the requested delegation to the Small Business Administration was withdrawn in favor of an expanded request for exemption.

^{3/} Certain other SBIC parties indicated they did not request exemption from particular sections of the '40 Act, but these are minor departures from the norm.

In connection with its opposition to the application, counsel for the Division questioned whether the exemptions might not preclude the tax advantages otherwise available to SBICs under Section 851 of the Internal Revenue Code. However, following the conclusion of the hearings and in their post-hearing filings of documents, both Applicant and the SBA attached for the record a copy of a letter dated July 15, 1969 from the Department of the Treasury to the Associate Administrator for Investment of the SBA. The letter stated that the granting of the exemptions would not affect the status of an SBIC under Section 851(a)(1), the pertinent provision of the Code, so long as the SBIC became and continued to be registered with the Commission as an investment company under Section 8(a) of the '40 Act.

In its Order providing for the hearing, the Commission directed that attention be given to the following matters and questions which the Division had advised are presented for consideration by the application:

"a. Whether the Commission has authority to grant the requested relief, i.e. exempt SBICs from substantially all provisions of the Act and delegate its regulatory authority over SBICs registered pursuant to Section 8 of the Act to the SBA. (With respect to Applicant's withdrawal of the request for delegation, see footnote 2 in the margin supra, p. 2).

b. Whether the granting of the requested exemptions and orders under the Act is (a) necessary or appropriate in the public interest, (b) consistent with the protection of investors and (c) consistent with the purposes fairly intended by the policy and provisions of the

Act; and

c. If the requested exemptions and orders are to be granted, what conditions, if any, should be imposed in the public interest and for the protection of investors."

In a subsequent order the Commission designated the undersigned to preside at the hearing, and on February 14, 1969 at the request of counsel for the Division a prehearing conference was held, during which certain procedures were adopted with respect to the manner of introduction of evidence on Applicant's case-in-chief, including the use of direct evidence in the form of prepared statements to be served on Division's counsel in advance of the appearance of the witnesses for cross-examination.

In accordance with an agreed schedule, the hearing commenced on March 17, 1969 and continued intermittently until May 6, 1969. Substantial testimony and voluminous documentary evidence were presented in support of the application by persons either currently engaged in or having prior experience in the industry, and official notice was taken of Commission files and documents at the request of one or more parties. Following the hearing the parties submitted proposed findings of fact, conclusions of law and briefs in support thereof in simultaneous filings, and reply briefs were filed in response to the initial filings. I have made the findings of fact and conclusions of law discussed herein on the basis of the record in these proceedings, after observing the witnesses who appeared before

me and with particular regard for the issues specified by the Commission in the Order.

At the outset I point out that it would be naive not to recognize that representatives of a regulated industry such as that in which the registered SBICs are engaged would wish to mitigate the burden of regulations to the extent practicable: and where the regulations are deemed excessive and also are imposed by more than a single regulatory authority, both consciously and unconsciously the burden of such regulations might be exaggerated. In evaluating the evidence I have kept this in mind.

Here the emphasis in support of the application has been on the burden of "dual regulation" by both SBA and the Commission. That term is used broadly herein to include not only current requirements of both agencies for filing reports, documents, and exemptive requests, whether such requirements duplicate or differ as between the agencies, but also to include regulations which prohibit or restrict activities of SBICs where they are imposed only by the '40 Act and its implementing regulations issued by the Commission, even though not also imposed by the SBA.

The thrust of the arguments in support of the application, and these are also urged by the SBA, is that the SBA, either under its current regulations implementing the SBI Act or under regulations which it can promulgate under that Act, can and will effectively supervise the SBICs in a manner consistent with the protection of investors and the purposes of the '40 Act. Counsel for the SBA assert

that an unconditional exemption from all '40 Act provisions is necessary and appropriate in the public interest. The one side, consisting of Applicant and SBA, concedes that the main thrust or essential purpose of the SBI Act is the effective utilization of funds to assist small business companies through the SBICs whereas the main thrust or purpose of the '40 Act is the protection of investors. But the SBA insists that it has had sufficient experience under the SBI Act and has sufficiently competent personnel who can accommodate and reconcile both the effective protection of investors and also the effective assistance to small business with which SBA is charged by the Congress. This one side contends, therefore, that the burdens imposed upon the small business investment company program and the consequent danger to that program and to small business as a result of dual regulation must now be considered, and that these considerations support the argument that the Commission can and should cease to exercise its authority in those areas in which SBA can and will supervise the SBICs with appropriate regard for the protection of their public investors.

The record is replete with testimony persuading me that dual regulation is a serious burden upon and inhibits to a material extent the viability of the SBIC industry. The burden falls upon all registered SBICs: on the larger ones, which can or should be able to furnish to small business concerns the significant long-term debt and equity capital essential to a successful program under the SBI Act, as well as on the smaller ones, where the expense of compliance with dual regulation is inordinately high when measured against the size of the operations and proposed transactions.

The record shows, with respect to the small business investment industry, that the registered SBICs are substantially larger than the non-registered. SBA figures as of September 30, 1968 show that of total assets of \$638.5 million of all of the SBICs reporting to SBA, the assets of 44 registered SBICs which reported were approximately \$260.8 million, or just over 40%, while the 378 reporting non-registered SBICs had assets of \$377.7 million, or approximately 60%. But the trend is for the registered SBICs to pull assets out of the program, frequently by forming parent-subsidary corporations and transferring assets from the program into comparable activities which are not subject to Commission supervision under the '40 Act.^{4/} Conversely, there is no trend toward entry into or expansion of the

^{4/} For example, Boston Capital Corporation in 1967 decided to surrender its SBIC license; in 1968 Greater Washington Investors, Inc. formed a subsidiary corporation to accomplish purposes mentioned in the text. Cf. In the Matter of Capital Southwest Corporation, Investment Company Act Release No. 5827, September 30, 1969.

The testimony also disclosed that the management of Delta Capital Corporation, which was licensed in 1961, has decided to liquidate the SBIC, primarily because of dual regulation. The prepared statement of John C. Laslie, Vice President, reads in part:

" . . . investing risk capital in small and untried businesses while at the same time attempting to comply with the rules and regulations of two different federal agencies has proven impossible." On cross-examination, however, it was clear that regulations of SBA and its restrictive rules concerning real estate were in no small measure also accountable for management's decision.

Growth Capital Corporation formed a subsidiary, Growth International Corporation, and it, also, withdrew substantial assets from the program in 1967.

program, either by non-public SBICs going public and thus increasing the funds available for assistance to small business or by the creation of SBICs by persons not now in the program. The testimony indicates not only that dual regulation is a prime reason for refusal of non-public companies to go public but also that officials of companies now subject to dual regulation advise others to avoid it, almost at all costs.^{5/}

I have no doubt that the representatives of the industry who testified, despite some exaggeration or misunderstanding of difficulties and delays previously encountered in connection with Commission supervision, sincerely believe that the industry is excessively and unduly burdened by dual regulation and that relief is required if the industry is to survive. The testimony with regard to the need for the filing of numerous reports with both agencies, some of the reports differing in content or format despite Commission efforts at accommodation; the testimony with respect to necessary delay when speedy action is essential; with respect to the expense involved, especially onerous for SBICs with small and limited capitalization, in studying the need for exemptive authority in order to consider or to accomplish potential transactions; with respect to the danger of entering into a void contract because of inadvertent violation of a complex Commission regulation; and the testimony with respect to time

^{5/} The record also contains hearsay testimony on the limitation of the volume of assets in the program, some of which is extremely difficult to evaluate. Witnesses testified, for example, that officials of non-public companies have stated that they would be willing to go public if it were not for dual regulation. (Whether this would be conditioned upon or subject to total exemption from the '40 Act is not indicated; and whether these are resolute statements of company position is doubtful). While I credit the witnesses, I ascribe little weight to such hearsay testimony.

and expense of management, attorneys, and other personnel who are involved in filing dual applications for exemptive authority, frequently in situations where exemption is doubtful, are among the factors which convince me that serious effort should be made by the Commission to mitigate the burdens imposed upon the industry by dual regulation, provided that this can be done within the standards and limitations of the Commission's exemptive authority and responsibility under Section 6(c)^{6/}. The above problems relate particularly to Section 17 and the Rules thereunder.

While concentrating their attack on the problem areas which the application seeks to change, the industry representatives concede that even total and unconditional exemption from the '40 Act would be no panacea. The stringent federal budgetary limitations recently and currently imposed upon the lending power of the SBA are a severe handicap to the performance of the functions of the SBICs. And for reasons discussed below, total and unconditional exemption is neither possible nor practical. The extent and measure of the help which would be afforded by the exemptions suggested below is problematical, but steps in the direction are necessary and will afford some relief and encouragement to persons now in the industry and may afford some

6/ Even though a few of the "problems" with respect to which testimony for Applicant was received are illusory or imagined, the very fact that representatives of the SBIC industry are under the impression that they exist militates somewhat against the potential growth, if not the survival of the industry. By way of example only, it was not recognized by all witnesses that adoption of a Commission rule under Section 17(d)(6) of the '40 Act had materially diminished the need for certain exemptive applications. (The complexity of Section 17 and the rules thereunder was the subject of much testimony by past and present representatives of the industry.)

Conversely, however, it is recognized that the testimony describes
(continued on following page)

encouragement and stimulus to potential entrants. I believe it is an imperative obligation that the Government which created the program should not, without purpose or plan to do so, stifle it or frustrate its development.

Counsel have expressed opposing arguments with respect to the somewhat vague term "public interest" as it is used in Section 6(c). Applicant and SBA argue that public interest embraces a regard for the success of the SBI program and for the Congressional and national concern for the success of small business. But the Division insists that a narrow construction of the term is required by Section 6(c); that the SBIC program is not to be considered by the Commission in weighing an application for exemption under that Section; and that protection of investors rather than national problems should be the concern of the Commission.^{7/} The Division also argues that "findings of hardship or difficulty incidental to compliance with the ['40 Act] are not material or germane to proceedings under Section 6(c) to determine whether exemptions from any or all of its provisions should be granted."

6/ (continued)

typical problem areas of dual regulation, and that the testimony could not purport to disclose all situations where SBICs were precluded from entering into transactions because speedy decisions were required but were not possible; where investment opportunities had to be abandoned with or without consideration of Section 17 problems; or where expenses or delay were considered insuperable under the circumstances of dual regulation.

7/ The Division's argument goes further and denies that there is ". . . assurance that the program will succeed even if the proposed exemptions are granted, especially in light of the fact that the record does not establish that the Investment Company Act has impeded the success of SBICs."

Both of these positions seem narrow. I believe that the Commission must consider public interest broadly, as it has done in the past,^{8/} and that in considering the requested exemptions it cannot disregard the Congressional intent to facilitate the formation and growth of SBICs. I believe, also, that hardship and difficulty incidental to compliance with the '40 Act are germane to the Commission's consideration of public interest under Section 6(c), and that if, as witnesses testified, these factors have induced withdrawals of registered SBICs from the program, and if, again as witnesses testified, these factors have impeded and continue to impede entries into and endanger the program, such hardships and difficulties are problems

8/ See In the Matter of J.D. Gillespie, Trustee, 13 S.E.C. 470, 480-481 (1943), where the Commission discussed the possible encouragement of the purchase of government bonds to aid in the war effort as a matter of public interest under Section 6(c).

Cf. Investment Company Act Release No. 1945, January 28, 1954, (to be found in 19 F.R. 754, February 9, 1954), where the Commission's notice of proposed rule-making which eventually resulted in current Rule 7d-1 under the '40 Act, under which Canadian management investment companies may request orders permitting registration, read in part:

"In line with the policy of this government to facilitate and encourage foreign investments, the Commission directed its staff to endeavor to formulate the 'special arrangements' which would meet the standards of Section 7(d)."

Cf. American-South African Investment Co., Inc., 38 S.E.C. 546 (1958).

In Investment Company Act Release No. 3361, November 17, 1961, the Commission deemed it appropriate under Sections 6(c) and 38(a) to exempt SBICs from certain requirements of Section 17(a), 17(d) and 18(c) of the '40 Act ". . . in view of the public interest to be served as expressed in the Small Business Investment Act of 1958 (SBI Act)."

It would also seem that unless "public interest" were broader than the Division suggests, many exemptions heretofore ordered by the Commission, either on specific application or in broader Rules, would have been neither appropriate nor necessary in the public interest.

which must concern us at this time as matters of public interest.

In this connection the Division contends that the testimony of the president of one of the non-public SBICs "shows only that his company prefers not to subject itself to compliance with the Investment Company Act by 'going public' and that the testimony fails to establish that the company could not function successfully as an SBIC if it chose to make a public offering and became registered under the Investment Company Act." This argument is hardly an answer, for if the persons in the program and those potentially available to the program are refusing to continue in it or are failing to enter it to a significant extent, as the evidence indicates, then the viability of the program is in danger, whether or not the reasons for such attitudes are entirely well-founded. Expense, delay, and also hardship in complying with the requirements of dual regulation are among the burdens which must be evaluated, and even if some of these burdens, after these many years of SBIC operation are unfortunately exaggerated in the minds of the interested persons upon whom the industry must rely, they cannot be ignored.

Nor is it an answer to the application that, as the Division points out, certain SBICs have grown dramatically despite dual regulation. The evidence does not, of course, disclose whether such growth has

9/ American Participations, Inc., et al., 10 S.E.C. 430 (1941) does not hold to the contrary. Where, as here, hardship and difficulty are part of a serious threat to a program established by Congress and important to the nation's economy, they constitute more than mere "inconveniences or impediments". Of course, if it were found, as in American Participations, that the factual evidence presents "no substantial basis for a conclusion by us that compliance with the provisions of the Act will destroy these applicants or that the grant of the proposed exemption will preserve them", exemption under Section 6(c) would be inexpedient and inappropriate. I do not reach such a conclusion here.

resulted from especially fortunate or wise investments, from superior management or exceptional opportunities, or from other causes. The more important consideration is that although the program itself has been helped by such successes, if it is nevertheless endangered by Commission regulation, reasonable efforts to mitigate the dangers must be made.

Part of the background of the filing of the application includes a long history of efforts to obtain both Commission and Congressional action exempting SBICs from Commission regulation. Apart from the many applications to the Commission by individual SBICs for the exemption of specific transactions, some of the efforts of Applicant and the SBA to obtain broader Commission action have been in the form of proposed exemptive rules; others have been made at meetings with Commission staff, including conferences and submissions in connection with the instant application. Some of these efforts have produced results which Applicant insists are inadequate, and it asserts that broader exemption is necessary to the survival of the program.

Applicant and SBA stress the significant difference between the investments of an SBIC and those of an open-end management company or mutual fund, some of which differences were discussed in the testimony. For example, the SBIC is required by law to make direct investments in small business concerns, and it generally holds its equity investments in newly-created and speculative ventures rather than in the securities of well-established companies. Its securities are generally unregistered and unmarketable: they are held for long period of time in portfolio

companies which sometimes need almost complete supervision by the SBIC, including accounting, engineering and administrative counselling. Such portfolio companies frequently have required the infusion of additional funds by the SBIC without delay, but speedy decisions have been prevented by the complexities of Section 17 and rules thereunder relating to transactions of affiliated persons.^{10/} The mutual fund, conversely, usually invests in well-established listed companies and is not committed to long term or risk capital ventures: its investment opportunities are broader, and its assets and income generally are much more substantial.

Efforts to obtain relief from dual regulation by Congressional action have been only partially successful. Commission representatives have generally opposed broad exemptions in testimony before various committees, and despite committee reports and recommendations frequently favorable to relaxation of Commission oversight, Congress has been reluctant to enact broad exemptive legislation. So the Division argues that exemption by the Commission not only would jeopardize investments which the '40 Act was designed to protect but also would abrogate the expressed policies of Congress. Conversely, Applicant contends that if SBICs had been in existence at the time of the enactment

^{10/} From time to time the Commission has assisted with broad exemptions relating to possible conflicts of interest and arising from the prohibitions of Section 17 and rules thereunder. For example, Rule 17a(6), promulgated in Investment Company Act Release No. 3968, April 29, 1964, exempted from the prohibitions of Section 17, investments by SBICs in small business concerns which are affiliates of an SBIC by reason of a prior investment or investments therein. This Rule obviated the need to apply for a Commission order permitting a proposed investment where an earlier investment in the business concern had been made.

of the '40 Act, Congress would have expressly recognized the difference between SBICs and the typical investment company or mutual fund which had created and presented the serious abuses and problems toward which the provisions of the '40 Act were aimed,^{11/} and would have exempted SBICs in Section 3(c) along with the financial institutions of a "similar type" such as banks, savings and loan companies and finance companies.

Whether the differences between SBICs and other investment companies or mutual funds is as significant as Applicant and the SBA suggest, or whether the resemblance is as close as the Division urges throws little light on what the legislative intent in 1940 would have been if SBICs had then existed. The failure of Congress to exempt public SBICs from the overall coverage of the '40 Act at the time the SBI Act became law in 1958 is more meaningful and reflects the view of Congress at that time.^{12/} This, of course, is part of the picture. So, too, is the failure of Congress on several occasions to take favorable action on bills which would exempt SBICs from Commission supervision with respect to certain activities or transactions. As pointed out by Applicant, Congressional committees have expressed concern about dual regulation, and Commission officials, including former Chairmen, have at times suggested to such committees, among other bodies, that because the Commission has authority to exempt SBICs to the

^{11/} The abuses of investment companies at which the '40 Act was directed were broad. They were "particularly detrimental to public investors" and included self-dealing by insiders in the form of unfair sales and purchases of securities and other properties to and from investment companies. See Report of the Securities and Exchange Commission, Part Three, Chapter VII, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies.

^{12/} Congress was mindful of the problem in 1958. For example, Section 307(c) of the SBI Act provides limited exemptions for SBICs from the '40 Act requirements as to the capital structure of an investment company.

extent appropriate, specific legislation was unnecessary.^{13/} I do not speculate on the effect such statements may have had on proposed legislation; but it would appear that further and perhaps more intensive efforts on behalf of SBICs to obtain exemption through legislation have been to some extent aborted by such statements.^{14/} The testimony and statements before committees also reveal strong objections to some of the proposed changes,^{15/} and some of these objections are now urged or suggested in the briefs of Division counsel in this proceedings.

Applicant's reply brief (to which the Division in the normal course of these proceedings could not respond) states that:

"NASBIC's most recent effort to obtain statutory exemptions from the Investment Company Act of 1940 came in 1963 with the introduction of S. 1427, a bill which would have transferred SEC regulatory authority over

^{13/} For example, Chairman Gadsby stated to the American Management Association on December 1, 1958, that ". . . what with the exemptive powers granted . . . by section 6(c) of the Investment Company Act . . . the SEC is given authority to apply with very great elasticity its regulation in the field opened up by the Small Business Investment Act. I have no doubts whatever but that the Small Business Administration and the Securities and Exchange Commission, working together, will be able to lay out a clear, simple, and safe course for these new enterprises to follow with the minimum of governmental interference consistent with the general public and investor interest." Briefing on the Investment Act, Committee Print, Senate Committee on Banking and Currency, 85th Cong., 2d Sess., p. 29 (1958).

^{14/} In 1961 Chairman Cary said, concerning proposed legislation and with reference to the conflicting views of SBA and the Commission: "We have worked very closely with the SBA, and indeed at the present time, as you can note, on three major points we are working with them in the belief that through our exemptive powers we can work out something that seems generally agreeable to them."

^{15/} In hearings in 1961 before Subcommittee No. 2 of the House Committee on Banking and Currency on H.R. 6672, 87th Cong., 1st Sess., Chairman Cary detailed objections to proposed amendments of the SBI Act which would exempt SBICs from certain prohibitions of the '40 Act. See, for example, page 92. See also Chairman Cary's testimony in 1961 on S. 902, 87th Cong., 1st Sess., at pp. 127-128.

SBICs to SBA. The bill was introduced in the Senate at the request of NASBIC by Senator Harrison Williams, Chairman of the Securities Subcommittee of the Senate Banking and Currency Committee. The scheduling of hearings on that bill was deferred on receipt of informal assurances from the Commission that problems encountered by SBICs under the Investment Company Act of 1940 were under active review by the Commission."

As indicated above, Applicant and SBA contend that subsequent relief has been inadequate.

While the effort to divine the intent of Congress is important with respect to the issues before us, it is something of a speculative project. In this effort we are not confined to a study of the '40 Act and its legislative history and amendments, but the spectrum includes other legislation such as the SBIC Act and its amendments. In 1967 Congress amended the SBI Act to require that SBA annual reports should thereafter include

"A report from the Securities and Exchange Commission enumerating actions undertaken by that agency to simplify and minimize the regulatory requirements governing small business investment companies under the Federal securities laws and to eliminate overlapping regulation and jurisdiction as between the Securities and Exchange Commission, the Administration, and other agencies of the executive branch." 15 U.S.C.A. 687(g)(1)(H).

* * * *

"(J) Actions undertaken by the Securities and Exchange Commission to simplify compliance by small business investment companies with the requirements of the Investment Company Act of 1940 and to facilitate the election to be taxed as regulated investment companies pursuant to section 851 of Title 26." 15 U.S.C.A. 687(g)(1)(J).

Such legislation signifies that as recently as 1967 Congress recognized that dual regulation existed and did not intend that SBICs be totally

exempt from Commission supervision or control. But it also indicates a Congressional concern for the problems that dual regulation imposes on SBICs.

As pointed out by the Investment Company Institute, an association of mutual funds, in a letter to the Commission dated February 12, 1969, commenting on the subject application,^{16/} the language in (H) above "simplify and minimize" should not be equated with "wholesale and indiscriminate abdication of responsibility" and the intent of Congress to reduce "overlapping jurisdiction" does not purport to preclude concurrent regulation by two agencies representing different aspects of public interest. The Division's brief also urges that the statutory language does not suggest a relinquishment of jurisdiction.

I believe it is a fair conclusion, from the legislative enactments and committee reports, that Congress intends that dual regulation should be minimized by the Commission to the extent practical, within the limitations and standards of Section 6(c), and that Congress would prefer, if it can do so, to defer to the expertise of the Commission in determining the extent to which exemptions can be granted in accordance with those limitations and standards.

16/ The Institute's letter was written to indicate its opposition to the request for "delegation" of authority to SBA, as originally stated in the application. The letter expressed the view that the Commission has no authority to delegate its responsibility to another agency, that "such delegation would be contrary to the will of Congress, and that it would be inconsistent with the public interest in the protection of investors."

The Institute's letter was in response to an invitation in the Order to persons desiring to be heard or otherwise participate in these proceedings. No other comments or requests for participation were received, apart from the communications of other SBIC members of Applicant who joined in the application.

Commission decisions and Congressional testimony by former Chairmen reflect that the Commission has never doubted its authority to grant broad exemptions from the '40 Act under Section 6(c), but it has regarded this authority as one which should be cautiously exercised. As stated in American Participations, Inc., et al., 10 SEC 430 (1941) at 437 in the margin:

"We may assume that our powers under Section 6(c) are ample to authorize the type of relief sought. But the wisdom of the exercise of such powers is another matter. The very breadth of a power to exempt any person, security, or transaction from any provision of the Act places upon us a grave responsibility that such power be exercised with the greatest circumspection. We must be alert to guard against the possibility that this Commission, established to implement the legislative will to protect investors, become the instrument through which the expressed policies of Congress are thwarted in case by case grants of exemption to any applicant who files and presses an application."

In Transit Investment Corporation, 28 S.E.C. 10 (1948), the Commission said, at 14, 15:

"The argument of the staff is that Section 17 as a whole sets forth the powers of this Commission with respect to dealings between affiliated persons and registered investment companies; that Section 17 contains within itself certain exceptions; and that these self-contained exceptions exclude the possibility of other exceptions under Section 6(c).

Section(6)(c) contains no qualification or limitation as to the sections of the Act from which an exemption may be granted or as to the types of prohibited transactions which may be exempted. Nor is there anything in the legislative history of that section which indicates a Congressional intent that its application be so limited. The exemption may of course be granted only where it satisfies the conditions stated in Section 6(c), and we recognize our responsibility to exercise with circumspection the broad power conferred, but we find no basis express or implied for any further restriction of the nature contended for by the staff."

More recently, in Matter of First National City Bank, Investment Company Act Release No. 4538, March 9, 1966, aff'd sub nom. National Association of Securities Dealers v. Securities and Exchange Commission (D.C. Cir., July 1, 1969, reh. den. August 15, 1969), CCH Fed. Sec. L. Rep. ¶92438 at 98065, the Commission granted certain exemptions from sections of the '40 Act pursuant to Section 6(c), thereby permitting the applicant bank to act as investment adviser to and supervisor of a collective investment fund operated as an open-end investment company. After reaffirming, by quoting from The Prudential Insurance Company of America, Investment Company Act Release No. 3620 at p. 8 (January 20, 1963), that Section 6(c) was put into the '40 Act

" . . . for the purpose, among others, of permitting the exemption of persons 'who are not within the intent of the proposed legislation [citing Sen. Rep. No. 1775 (76th Cong., 3rd Sess.) at p. 13] even though such persons come within the scope of the Act by virtue of its specific provisions"

the Commission, now quoting from Transit Investment Corporation, supra, continued,

" . . . that the 'purposes fairly intended by the policy and provisions' of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to **resort** to Section 6(c) to exempt a transaction from any provision of the Act."

Thus in considering the purposes and policy of the '40 Act, Section 6(c) must be recognized as one provision which, along with all other

provisions, expresses the views of Congress, and it follows that changes in the scope of the literal language by Commission exemption in proper cases was intended and provided for in the Act and is a part not only of its provisions but also of its policy. The exercise of this prerogative to exempt is a matter within the judgment and expertise of the Commission. Congress did not intend that the responsibility and authority to exercise it should be renounced in deference to Congressional authority, where the standards of Section 6(c) can be met.

It is my view that in certain respects these standards are reasonably met, and that under the evidence presented at the hearing Applicant has sustained its burden of proving that it is appropriate in the public interest that some exemptions from provisions of the '40 Act should be granted, subject to appropriate conditions. Section 17 of the '40 Act has borne the brunt of Applicant's evidentiary attack. The applicability and effect of Section 17 which pertains, as the title indicates, to "Transactions of Certain Affiliated Persons and Underwriters" have become extremely complex, primarily by reason of the nature of the subject matter but also as a result of the Commission rules thereunder, both exemptive and prohibitive.^{17/} Section 312 of

17/ Rules 17a-1 through 17a-7 are exemptive under conditions and circumstances described therein, as amended from time to time.

Section 17(d) is not self-operating, but authorizes the Commission to adopt rules designed to protect investment companies and their investors from overreaching by affiliated persons where the investment company and the affiliated person have a joint or a joint and several participation in a transaction. Rule 17d-1 is prohibitive in nature, but now contains an exemption with respect to certain transactions, including loans made to a small business concern by a bank and a licensed SBIC. The Rule requires reports to the Commission with details of transactions "at such time, on such forms and by such persons as the Commission may from time to time prescribe."

the SBI Act, as amended,^{18/} "Conflicts of Interest," relates to the same area as Section 17, and provides in part that the SBA shall adopt regulations "controlling conflicts of interest which may be detrimental to small business concerns, to small business investment companies, to the shareholders of either, or to the purposes of this Act. . . ." In implementation of this Section, SBA adopted its Regulation 107.1004 (13 CFR 107.1004). This Regulation, together with a broadly inclusive definition of the term "associate of a licensee" in Regulation 107.3, and the limitations on "Sale of portfolio securities" in Regulation 107.1005 appears to afford, subject to competent administration by SBA, reasonably adequate protection against potential conflicts of interest, although the coverage is narrower than that of Section 17 and Commission rules thereunder.

Counsel for SBA announced at the hearing that he was authorized to read into the record a statement by SBA strongly supporting the application, and asserting that the SBA now has the experience and expertise to carry out its responsibilities under the mandate of Congress in the SBI Act. As indicated above, that mandate is concerned with the success of the program, and it includes, by necessary implication and also expressly, the protection of investors in SBICs.

No convincing testimony or evidence, pro or con, reflects upon the ability of the SBA to administer and supervise with adequate care

^{18/} 15 U.S.C. 67d, added February 28, 1964, (78 Stat. 147).

and competence the areas of potential conflicts of interest.^{19/} If the SBA does not have and does not continue to maintain a staff in sufficient numbers and with adequate expertise, alertness, imagination, and integrity, moral and political, to supervise the industry with competence, the program cannot succeed. Necessarily, its staff must be able to frustrate the efforts of persons who may attempt to profit by questionable or dishonorable activities -- attempts which will take the form of efforts at self-dealing by some, as well as attempts by questionable persons to enter the program, an administrative area over which SBA has had and continues to have jurisdiction perhaps primary to that of the Commission.^{20/} If the SBA cannot or does not adequately supervise the program, investors in SBICs will be defrauded, the '40 Act to the contrary notwithstanding. If it supervises adequately, the purposes of Section 17 will be accomplished.

The Division delicately raises some question concerning the ability of the SBA to administer investor protection regulations "with the same impartiality as the Commission", and expresses doubt concerning the adequacy of the SBA staff's "size and expertise to administer investor protection regulations in an SBIC industry which may well be expanded in numbers by the granting of the subject application."^{21/}

^{19/} This is stated as a fact and not in derogation of any party. I recognize the difficulty, if not the impossibility of proving the competence or incompetence of an agency's supervision in a hearing of this nature, assuming such matter is germane. But I do not accept the position urged by SBA that testimony which is not controverted must be adopted by me as the trier of the facts. And more specifically, I do not feel bound to the position of industry officials who expressed opinions that SBA now adequately protects SBIC investors and that no Commission oversight is necessary.

^{20/} Cf. Section 314(c) of the SBI Act (15 U.S.C. 687f) and Section 9 of the '40 Act.

^{21/} The Division did not request that official notice be taken of a (continued on following page)

No agency within the Government has a monopoly on talent, ability, or integrity, and if the SBA now lacks the personnel necessary to administer the program successfully, this should be apparent to those who must take remedial steps. I see no reason to doubt adequate administration and under the conditions of exemption which I suggest below with regard to continuation of SEC oversight, I believe that both the protection of investors and the relief required by SBICs from the burdens of dual regulation can be accommodated.^{22/}

On November 17, 1961, in Investment Company Act Release 3361 the Commission adopted certain rules exempting SBICs from some of the prohibitions of Sections 17(a), 17(d) and 18(c) of the '40 Act, . . . stating, in part:

"The SBIC program is too recent for the accumulation of any substantial experience which would demonstrate the desirability of complete exemptions in the respects indicated, as has been requested, from these provisions of the Act. However, in view of the public interest to be served as expressed in the Small Business Investment Act of 1958 (SBI Act), the Commission believes it is appropriate for an experimental period to grant exemptions with certain protective conditions. This approach will afford the Commission and all other interested persons an opportunity to examine the operation of SBICs and to reconsider the exemptions if that should appear necessary."

21/ (continued from preceding page)

Senate Committee document reflecting adversely on SBA's administration of the program, and no argument on the contents of the document is in the record. The document is now almost 2 years old, and speaks of still an earlier period. To the extent that it may accurately point out pre-existing deficiencies I believe we must assume that they have been or will be corrected. See Senate Report No. 958, 90th Cong., 2nd Sess., Investigation into Small Business Investment Companies, Report of the Committee on Government Operations, by its Permanent Subcommittee on Investigations.

22/ Counsel for Applicant and SBA also point out that apart from SBA's regulations on conflicts of interest it has other regulations and procedures which serve the purposes of investor protection. These include the audits and examinations conducted by SBA staff. In Matter of First National City Bank, supra, the Commission seems to have placed some measure of reliance on the periodic examinations of national banks by the staff of the Comptroller of the Currency.

Now, eight years later, the Commission with understandable hesitation is evaluating the further relinquishment of control. The Division urges that it would be unwise to relinquish any control, but evidence supporting its negative position is lacking. I do not suggest that further relief from dual regulation is as important to the success of the program as would be a favorable change in business conditions, or that it would be as dramatic as a loosening of the "tight money" situation now disturbing the economy generally and the SBIC program in particular. But given a reasonably favorable business climate and Government cooperation, I believe it would be a meaningful contribution to the program's success.

Although the SBA urges that the Commission relinquish totally its responsibility over SBICs and that all of the requested exemptions be granted unconditionally, a more radical position than that urged by Applicant, I do not find that such grant is either necessary or appropriate in the public interest at this time. It is my opinion that the registered SBICs should be exempted from Section 17 for reasons stated above, subject, however, to the following conditions:

That for a period of one year, ^{23/} beginning with the effective date of the exemption under any order issued on the subject application, copies of all applications by registered SBICs for exemption pursuant to SBA

23/ The period of one year should be subject to further extension by order of the Commission issued prior to the expiration of the year, either after hearing ordered by the Commission or by ex parte order, within the sole discretion of the Commission.

Regulation 107.1004(b) or Regulation 107.1301

"Exemptions" shall be furnished for informational purposes to the Commission, and the SBA shall furnish to the Commission, contemporaneously with the issuance thereof, copies of all exemptions issued under said Regulations.

In my view ~~that~~ Applicant also has sustained its burden of proof that exemption is appropriate in the public interest and "consistent with the protection of investors and the purposes fairly intended by the policy and provisions "of the '40 Act with regard to the prohibitions in Section 18(d), and perhaps in Sections 19 and 23, against the issuance of stock options by an investment company. Here, too, I believe that accommodation should be made to the exigencies of the situation. ^{24/}

The evidence discloses that because of these prohibitions in the '40 Act several registered SBICs have suffered a loss of top management personnel and that several have been unable to attract the competent high-level officials essential to efficient operation. Expertise in such areas as finance and marketing, among others, are essential at the SBIC management level. But defections from employment and disinterest in accepting such employment with registered SBICs have resulted in part from the prohibitions against the issuance of stock options. ^{25/} With respect to several instances

^{24/} Cf. The Prudential Insurance Company of America, 41 S.E.C. 335 (1963), at 341-2: "The essential problem presented is the accommodation of two schemes of regulation - insurance and investment company." And at 353: "The Commission is not doctrinaire in providing some flexibility through exemptions."

^{25/} Some of the departures of high-level personnel from SBICs have followed offers by small business concerns which they have shepherded to success.

specified in the testimony, as well as in other instances not specifically described, I credit the evidence that this disability to compete with non-registered SBICs and with industry generally has been a serious burden to the registered SBICs and hence to the program. Now, perhaps more than ever, because of the monetary situation in the nation an SBIC must keep its funds to the extent that retention is possible, with a "promise" that if and when money becomes more freely available the reward for high calibre management will be forthcoming. One of the promises or inducements to good management in lieu of higher salaries is the stock option.

According to the testimony, some of the SBICs mentioned in fn. 4, page 7, supra, which have withdrawn funds from the SBIC program did so as a result, in part, of their inability to issue stock options. Moreover, an officer of one, Greater Washington Investors, Inc., testified with respect to stock options:

"If, for example, SBIC's [sic] who are also registered under the 1940 Act would be permitted to grant stock options, we would merge our parent into our subsidiary and operate solely as a SBIC."

Whether this testimony refers to the release of all restrictions on stock options, and whether it reflects more than an ephemeral view of one man while testifying is not clear, but it does reflect the importance of the problem to many persons operating registered SBICs. There is additional credible testimony in the record to the effect that some unregistered SBICs have failed or refused to go public partly because of the restrictions on stock options.

Neither the SBI Act nor SBA regulations prohibit the issuance of stock options and among SBICs only the registered are competitively disadvantaged. I believe that the ability to issue restricted stock options would alleviate the personnel problems of these SBICs and that relaxation of the prohibitions should permit them at least to approach a competitive position with non-public SBICs and with operating companies seeking the same high-level management. The record contains no evidence relating to or reflecting the extent to which non-registered SBICs have issued such options, or the consequences of the issuance of options by such companies or by operating companies in industry.^{26/} Nor does it contain evidence or argument by the parties concerning reasonable restrictions which might be imposed upon their issuance by registered SBICs. I view this as a problem which can best be accomplished by meetings and discussions of the parties, so that the views and needs of each can be recognized and a reasonable and practical solution achieved. I make no attempt to spell out more specifically the guidelines or limitations, but believe that the exemption from Commission prohibitions should be conditioned on SBA adoption of permissive regulations acceptable to the Commission and that such accommodation should be reached.

In summary, the relief suggested in this initial decision is designed to enable registered SBICs, which must lend to or invest in securities of small business concerns to whom credit has generally been denied by all conventional sources, to make relatively speedy

^{26/} The divergent views on the expediency of a corporation's issuance of stock options are set forth in a host of pamphlets, legal periodicals and texts which it would serve no purpose to discuss. Cf. for example, Henry Ford II, "Stock Options Are in the Public Interest", Harvard Business Review, July-August 1961; and Erwin N. Griswold, "Are Stock Options Getting Out of Hand", Harvard Business Review, November-December 1960.

decisions regarding the problems of their portfolio companies where necessary, by avoiding the complexities of the rules and their administration under Section 17. A small company, as was stated with respect to portfolio companies, "can go down fast, and delay is costly." I believe we must rely upon the judgment of SBIC management and on its ability to act wisely and expeditiously, subject to the administration and the oversight mentioned above. The testimony indicates that the Investment Division of SBA, which has as its sole function the supervision of SBICs, is familiar with the individual SBICs and their problems and can give priority to their applications. There should be no added delay, nor any inhibitive fear that protracted delay might ensue.

I believe, also, that the ability to compete by attracting and retaining competent and knowledgeable management is essential, and that potential gains in the form of restricted stock options with their tax advantages, among others, are a necessary aspect of that ability. Whether reasonably permissive regulations can be worked out to the satisfaction of the Commission, the Applicant and the SBA is not at all certain. In my view, such efforts should be made.^{27/}

Exemptions along the lines set forth herein should obviate another costly and protracted chapter in the hearings which have been held by Congressional committees over the years since 1958. Another chapter, it would seem, would produce much the same kind of evidence as was

^{27/} Applicant states that on February 20, 1962, it submitted a "Proposed Rule 18d-1 to permit the issuance of 'restricted stock options' and suggests, as an alternative to exemption that the Commission reconsider that proposal."

given in these proceedings.

In other respects I conclude that Applicant has not sustained its burden of proof that exemptions are necessary or appropriate in the public interest. This includes one specific area with respect to which there was substantial testimony, but I am nevertheless not convinced that it is necessary or appropriate in the public interest that an exemption be granted from the restrictions on the issuance of convertible securities as in Section 18 of the '40 Act. Other sections of the '40 Act are either inapplicable or of no regulatory significance to SBICs, as pointed out in the application; or, on the record in these proceedings do not restrict their activities to an extent that justifies consideration of exemptions under Section 6(c) in the public interest.^{28/} It is clear, of course, that the coverage of the provisions of all other statutes administered by the Commission, including the anti-fraud sections, the registration requirements, and the insider trading provisions remain in effect, and the '40 Act's reporting requirements for investment companies should afford to the Commission's staff further opportunity for oversight in administering the provisions of those other statutes with regard to registered SBICs.

Rule 16 of the Commission's Rules of Practice requires that an initial decision shall include, apart from the findings and conclusions with reasons therefor and other provisions, "an appropriate order." Because of what I regard a necessary lack of definitiveness at this stage of the proceedings in specifying the exemptions which I deem

^{28/} For tax purposes the application, as stated above, does not request exemption from the registration provisions of Sections 8 and 24.

to be "appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of Section 6(c), my order in this initial decision is also lacking in definitiveness. Accordingly,

IT IS ORDERED that the application be and the same hereby is granted and registered SBICs shall be exempt from the provision of the '40 Act to the following extent:

"From Section 17 and Rules thereunder, provided, however, that for a period of one year 29/ beginning with the effective date of the exemption under any order issued on the subject application, copies of all applications by registered SBICs for exemption pursuant to SBA Regulation 107.1004(b) or Regulation 107.1301 'Exemptions' shall be furnished for informational purposes to the Commission, and the SBA shall furnish to the Commission, contemporaneously with the issuance thereof, copies of all exemptions issued under said Regulations."

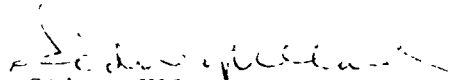
"As to Sections 18(d), 19 and 23 and Rules thereunder, to the extent such Sections or Rules or any of them prohibit the issuance by a registered SBIC of stock options to officers or employees, on condition, however, that such exemption shall become effective only upon the adoption by SBA of regulations satisfactory to the Commission with respect to the issuance of restricted stock options."

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of practice.

Pursuant to Rule 17(b) of the Commission's Rules of Practice, a party may file a petition for Commission review of this initial decision within 15 days after service thereof on him. Pursuant to

29/ See fn. 23, at page 25, supra, regarding Commission extension of this period.

Rule 17(f) this initial decision shall become the final decision of the Commission as to each party who has not, within 15 days after service of this initial decision upon him, filed a petition for review pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c) takes action to review this initial decision as to a party. If any party timely files a petition for review or if the Commission takes action to review as to a party, this initial decision shall not become final with respect to that party. ^{30/}


Sidney Ullman
Hearing Examiner

November 26, 1969

30/ All proposed findings and conclusions submitted by counsel for the parties have been considered, as have their respective arguments. To the extent that the proposed findings and conclusions are in accord with the views set forth herein they are accepted, and to the extent that they are inconsistent therewith they are rejected.