

**THE S. E. C. LOOKS AT
SMALL BUSINESS INVESTMENT COMPANIES**

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I have been asked to discuss how the disclosure and regulatory statutes administered by the Securities and Exchange Commission will affect small business investment companies operating under Public Law 699, commonly referred to as The Small Business Investment Act of 1958. This will involve a bit of crystal ball gazing on my part since the extent to which the various Securities Acts are pertinent to this new situation will depend somewhat upon factors as yet unknown in the sense that they cannot as yet clearly be defined or analyzed, and it may be that the practical application of the statutes will show difficulties now wholly unforeseen. However, in many respects, our course is perfectly clear, and it is equally clear that the corporate manager, the financier and the lawyer must give careful consideration to the impact of the Securities Acts when planning to proceed under the 1958 legislation.

The first step in setting up the machinery under this new legislation is the formation of a Small Business Investment Company, under state or federal charter. The capital of this investment company will be initially derived in part from the Small Business Administration and in part by the sale of stock to sponsors. These sponsors may be of two kinds. They may be governmental in character, such as state or a regional organization, in which event the Securities and Exchange Commission has no immediate interest, at least insofar as the initial sale of the securities of the Investment Company are concerned. On the other hand, it is contemplated that some at least of these concerns will be financed, aside from the SBA participation, through the sale of their securities to a segment of the general public. It is at this point that the Securities and Exchange Commission begins to be interested.

At the outset, I should mention that, after considering and weighing the many problems involved in affording assistance to small business and at the same time preserving adequate protection to the investing public, the Congress determined that any plan of assistance to small business which would involve public investment must be bottomed upon the time tested maxim that confidence can only be achieved and damage to the public avoided by adherence to elementary standards of open and complete disclosure and of fair dealing between the parties. To this end it was determined these new small business investment companies would be subject to the applicable provisions of the Securities Acts. It is only in a very few necessary connections that Congress made specific exemptive provisions, and generally the Commission is left with discretion to establish exemptions where and to the extent necessary.

The Small Business Investment Act contemplates that the small business concerns which are in need of new capital on a long term basis and cannot obtain it otherwise on reasonable terms, may apply for such monies to an investment company formed under the Act. Assuming all else to be favorable, such a small business will then issue and sell to the investment company its convertible debentures in the required amount. The Act also contemplates that the small business concern will invest nominally in the equity securities of the investment company. This feature may involve some technical points under the Securities Acts, but this can be ignored for the moment. In due course, if the subsequent activities of the small business prove to be profitable, the investment company may liquidate its holdings of the securities of the small business, either by sale of the debentures or by conversion and sale of the underlying stock, in either case at private or public sale, or, of course, by redemption.

Since this process which I have rather summarily described involves the issuance and sale of corporate securities, it is perfectly obvious that it also involves consideration of the jurisdiction of the Securities and Exchange Commission, which broadly covers activities concerning such access to the capital market. It is necessary, in order to consider how this scheme may be affected by the various Acts which are administered by the S.E.C., first to consider how much of this program has been left to our jurisdiction by the Congress under the 1958 Act, and in what respects the law calls upon the investment company or its borrower, to note the jurisdiction of the S.E.C., and what measures this agency has in mind to adopt in order to make sure that this legislation will accomplish its stated purpose without running counter to the purposes expressed in the nexus of statutes we administer.

These small business investment companies will be chiefly concerned with two of the Securities Acts. The first of these is the Securities Act of 1933, which was enacted to protect investors and the public in connection with the offering and sale of securities by processes designed to insure full disclosure of all relevant facts. The other is the Investment Company Act of 1940, which is a regulatory statute prescribing standards in the interests of investors and the public to govern certain of the activities of companies engaged in the business of investing in securities.

Before I address myself specifically to small business investment companies, it may be appropriate to consider generally the responsibilities of the Commission in the area of public financing. In the administration of

the powers and responsibilities vested in it by these statutes, the Commission is guided by two more or less overlapping standards, that of the public interest and that of the protection of investors. I say two standards, since the term "public interest" includes more than concern for the protection of investors as such. It requires the Commission to look beyond these immediate interests and to take into consideration the welfare of the economy as a whole. Thus, while it is looking to the protection of prospective investors in dealing with small business investment companies, it must be careful not to erect such burdensome requirements as to hamper the raising of capital needed by these companies to perform their function of providing funds for small businesses.

The Securities Act of 1933 has two basic objectives; one is to provide investors with information concerning securities offered for public sale and the other is to prevent misrepresentations and fraud in the sale of securities. The Act applies to the offering and sale of all types of securities not only by the issuer but also by any person in a control relationship with the issuer, and it is concerned with all types of securities, not only stocks and bonds, but also debentures, notes, evidences of indebtedness, investment contracts, voting trust certificates, certain oil and gas interests and, in general, any interest or instrument commonly known as a security, as well as some not so easily recognized as such. It seeks to accomplish its objectives primarily by requiring the registration with the Commission of all securities offered or sold by use of the mails or other instruments of transportation or communication in interstate commerce. There are, however, certain exemptions from registration, some of which are set forth in the statute while others are outlined in the Rules and Regulations of the Commission adopted pursuant to statutory authority.

Registration under the 1933 Act is the process whereby a registration statement is filed with the Commission and after a lapse of time becomes effective. The principal component of a registration statement is a prospectus which describes the issuer, its business and management and the proposed offering and furnishes certain financial and other information necessary to an informed investment appraisal of the offering. The registration statement must be signed by the issuer, a majority of the directors and certain of its officers and agents. Each such signature to a registration statement subjects each such person and his attorney and accountant to strict liability for material omissions or misstatements. Securities may not be offered for sale before the statement is filed and they may not be actually sold before it becomes effective, which is usually about three weeks after filing. The

staff of the Commission reviews the registration statement when it is filed and any inadequacies or omissions are normally brought to the attention of the issuer for correction. Each purchaser of the security so offered must be furnished with a copy of the prospectus at or before the time of purchase.

The Commission has adopted certain forms for use in registering securities under the Act, adapted to the circumstances of the particular securities to be registered. The Commission has prepared and has invited public comments on a proposed additional form (Form N-5) designed for use by small business investment companies. When the comments have been reviewed and considered, the form will be adopted by the Commission, which action will be announced in a public release.

I would not mislead you into believing that the registration of securities under the Securities Act is a perfunctory matter nor can I truthfully say that in the usual situation it is a simple or easy task. Registration necessitates the careful assembling and preparation of the material required to be contained in the registration statement and requires the draftsmen and signatories to make detailed disclosure of all pertinent facts concerning the proposed offering. This is an area in which the aphorism that "what you don't know won't hurt you" definitely does not apply. If you don't know, you must find out. The penalties are severe for false, misleading or incomplete statements.

As I have indicated above, the Securities Act provides in Sections 3 and 4 for a number of exemptions applicable to certain types of securities, to securities issued under certain circumstances and to certain transactions in securities. Most of these exemptions are not pertinent to our discussion. They cover, for example, federal and municipal securities, securities of certain cooperatives and railroad and certain other common carriers, certain exchange transactions, etc. Another exemption, commonly referred to as the "intrastate exemption" and described in Section 3(a)(11) of the Act, is not available for the securities of a registered investment company, and we may forget it for our present purposes. There are, however, two exemptions which do seem to be pertinent here, and which may make registration unnecessary under some circumstances.

The exemption which would probably account for the vast bulk of the exempt financing of Small Business Investment Companies is found in Section 4(1) of the Act which exempts, among other things, "transactions by an issuer not involving any public offering." It should be noted that this is not an

exemption of the security as such but is an exemption of a limited type of transactions in securities, and the full provisions of the Act apply to subsequent transactions in the same security. In common parlance, the language of the section has been turned around so that, instead of referring to transactions not involving any public offering, reference is usually made to "private transactions" or "private offerings."

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

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

* 346 U. S. 119 (1953)

Another factor which must be considered in determining whether a given issue is entitled to an exemption as a private issue is the size of the offering and the number of units offered. Frequently, a large issuer will place a sizeable issue of debt securities with a comparatively few institutional investors. Because of the ability of such institutions to insist upon and to receive information even more extensive than that usually provided in a prospectus and their ability to negotiate the transaction on equal terms, such private placements, as they are called, can be effected within the limitations of the exemption provided by Section 4(1). I rather doubt that this situation will be met in the usual placement under the 1958 Small Business Investment Act, but it should be noted that the purchase of convertible debentures of the small business enterprise by the Investment Company would be exempt from our jurisdiction under this exemption. Note, however, that such treatment would not be available in the case of a sale of such securities by the Small Business Investment Company, as to which transaction there would either have to be a registration or else some other exemption would have to be found to be available.

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

In addition to the exemptions contained in the statute, which require no filing with or action by the Commission, Section 3(b) of the 1933 Act gives

the Commission discretion to adopt rules and regulations exempting the offering of securities not in excess of \$300,000 upon such terms and conditions as the Commission may prescribe. The principal exemption which has been adopted under Section 3(b) and is currently of interest to small business is that provided by Regulation A. The availability of Regulation A is subject to certain terms and conditions which include the making of a filing with the Commission and the use of an offering circular containing certain specified information. While it is necessary to keep this exemption in mind, since it may be useful if the position of the Investment Company is liquidated by sale, it is not strictly pertinent to our present inquiry, since it is not available for securities of small business investment companies registered under the Investment Company Act of 1940.

At the same time that the Congress enacted the Small Business Investment Act of 1958, it inserted a new Section 3(c) in the Securities Act of 1933 authorizing the Commission to adopt rules and regulations exempting, upon appropriate terms and conditions, the offering of securities by investment companies licensed under the Small Business Investment Act. Acting pursuant to this new authority, the Commission has invited public comments on a proposed new Regulation E which is similar in many respects to Regulation A and which would exempt from registration under the Securities Act such issues in an amount not in excess of \$300,000.

The proposed exemption under Regulation E is not automatic, but is available only upon compliance with certain terms and conditions and subject to certain limitations. The exemption would not be available, for example, to an issuer if either it or its directors, officers, promoters or underwriters are subject to certain administrative orders, or have been convicted of or enjoined against certain misconduct. It should be noted, however, that the issuer in such case would not be barred from filing a registration statement covering the securities to be offered in the form I have previously discussed.

The first step toward meeting the terms of Regulation E would be for the issuer to prepare and file with the Commission what is called a "notification." This document is prepared in accordance with a relatively simple prescribed form and must set forth certain specified information in order that the Commission may determine whether or the extent to which the exemption is available. In order to assist in our review, the notification must be accompanied by certain exhibits, such as the underwriting contract, if any, and the consent of the underwriter to be named as such.

Regulation E would require that an offering circular be used in connection with the sale of the securities offered thereunder except in certain

cases involving offerings of less than \$50,000. With the exception of brief advertisements, the offering circular is the first written sales material which may be presented to the investor in connection with the offering of the security. It must, in any event, be in the hands of the investor not later than the date of the confirmation of the sale and prior to the payment of the purchase price of the security. The idea of requiring the use of an offering circular was one taken over from Regulation A. The requirement that an offering circular be used under Regulation A was adopted in large measure at the suggestion of the securities industry. It was felt that as a protection to those engaged in the investment business, as well as to the investing public, certain basic information should be furnished to each person to whom the securities are offered and that such material should be subject to the Commission's examination. This did not appear to impose any particular hardship because in most cases the honest issuer and underwriter would, in any event, prepare and use some form of offering letter or circular. Our experience has demonstrated the wisdom of this requirement and we believe that it is equally applicable, and for similar reasons, in the case of small business investment companies.

In the absence of specific requirements governing the content of such offering documents, issuers not sophisticated in the ways of the securities markets might be at a loss to know precisely what information we conceive ought to be included in the offering circular in the interest of fair disclosure. Consequently, the requirements as to the contents of an offering circular are set forth in a schedule attached to the proposed Regulation E. We believe that these requirements are limited to what would be regarded as the essential facts concerning the company and the securities to be offered.

The preparation of the notification and offering circular should not be much of a burden. The information required and described in the rule and the schedule is fundamental and is readily available to the company desiring to use the regulation and in fact will have to be submitted to the Small Business Administration. I believe that the procedure under the proposed Regulation E is as simple as it can be in view of the paramount necessity for protecting the American investor. The regulation itself, at first reading, seems rather formidable, but it should not be difficult to understand after a modicum of study. We are open, as always, to suggestions for improvement, but I must confess that we are presently satisfied that the proposed procedure involves the minimum of disclosure which the investor could reasonably expect under the Securities Act.

Filings under the new regulation will be made in the principal office of the Commission in Washington. This is necessary in order that such filings

be reviewed and correlated with necessary filings by small business investment companies under the Investment Company Act of 1940. I will come to this latter subject in a moment. Moreover, filing in the principal office will facilitate the maintenance of a close liaison with the Small Business Administration which has the primary responsibility of administering the Small Business Investment Act of 1958.

The Commission has nine regional offices and eight branch offices in strategically located cities throughout the country. Each such office has a staff of attorneys and accountants who are available to discuss an issuer's problems with its representatives prior to filing and to give such assistance as their workload permits in answering specific questions concerning compliance with the regulation, although I must add that our staff is not in position to participate in the actual drafting of papers. I am certain that free resort to this advice will help to prevent inadvertent as well as somewhat technical violations of law with all the headaches and expense involved.

Perhaps I should utter what is doubtless an unnecessary word of caution at this point. The requirements under the Securities Acts are in addition to, and in no wise in lieu of the requirements of the laws of the respective states. Many states have blue-sky laws under which a state administrator is usually empowered to specify the terms and conditions under which securities may be sold in that state. An issuer must smoke the pipe of peace with the appropriate state authorities as well as with the Commission before he may offer securities to the public.

As I have already noted, in enacting the Small Business Investment Act of 1958, Congress determined that small business investment companies authorized by that Act should also, in appropriate cases, be subject to the provisions of the Investment Company Act of 1940. An exception was made in connection with Section 18(a) of the 1940 Act which makes inapplicable to these particular investment companies the provision generally applicable that the indebtedness of an investment company shall have an asset coverage of at least 300% upon issuance. An exemption was also provided from the statutory prohibition against the declaration of dividends or other distributions on capital stock unless certain asset coverages on indebtedness publicly distributed are maintained. In administering this phase of the new legislation, then, the Small Business Administration will have the responsibility of seeing that sound capital structures are maintained consistent with the purposes of its enabling act. In other respects, the Securities and Exchange Commission is required to exercise its duties and responsibilities under the Investment Company Act.

Those companies operating to make capital available to small business under the Small Business Investment Act and which are to issue securities to the public will undoubtedly in the usual case be investment companies as defined in the Investment Company Act and thus subject to SEC jurisdiction. One important exception to this general statement is, however, specifically set out in Section 3(c) of the Investment Company Act, under which an investment company is excepted from regulation under the 1940 Act if its own outstanding securities are beneficially owned by not more than 100 persons and if it is not engaged in making or proposing to make a public offering of its securities. You will note that both these elements must be present, so that if a public offering is involved or proposed or if the company has more than 100 security holders, registration under the Investment Company Act would be required. In calculating the number of such holders of the investment company securities, the beneficial holders of the securities of any company which owns 10% or more of the voting securities of the investment company must be counted individually. A considerable number of the small business investment companies will doubtless be financed privately by a limited group of persons, thus bringing them within this exception. I have already discussed some of the factors which are of consequence in reaching a determination whether a public offering is involved under the 1933 Act. It would seem that the same considerations are pertinent here.

Small business investment companies for which Section 3(c) of the Investment Company Act will provide no exemption will be required to register with the SEC. Such registration is a separate process from the registration provided for under the Securities Act. This mechanism was originally designed to fit the usual investment company situation in the light of which the 1940 Act was written and has so far been administered. We appreciate the desirability of simplifying this procedure in the case of small business investment companies, however, and the proposed Form N-5 to which I referred earlier and which has been circulated for comment is designed to cover registration under both the Securities Act and the Investment Company Act. If this form is eventually adopted by the Commission, therefore, it will serve to comply with both statutes, and one filing is all that will be called for.

The Commission is most concerned with and sympathetic to necessary measures to aid small business in its efforts to raise capital. However, we feel that this should be done with due regard to investors who are expected to help finance these investment companies, and consistently with the intent of Congress in enacting the 1940 Act. The type of program contemplated by

the Small Business Investment Act appropriately lends itself to cooperative regulation by the two agencies of the Government concerned, each operating in its own sphere of expertise. In this pattern of regulation, the Securities and Exchange Commission would exercise its duties and responsibilities, with its primary interest in the protection of the public security holder. The Small Business Administration would presumably direct its activities to assuring that these proposed investment companies will appropriately channel the resources available to them to meet the capital requirements of the small business concerns with whose needs the Small Business Investment Act is primarily concerned.

Neither the Investment Company Act nor, indeed, the other statutes administered by the Commission, ought to be viewed as burdensome obstacles placed in the path of corporations which must raise money from the public. On the contrary, we believe that the standards of conduct imposed by the fabric of the statutes which we administer will be of great assistance in contributing to the successful operation of small business investment companies having a public interest. To the extent that investors are provided with the safeguards granted by this legislation, a more favorable climate for the flow of capital in this area can be expected.

The objectives of the Investment Company Act here are to secure honest and unbiased management of other people's money; to give security holders a substantial voice in determining the company's policies and in the selection of management; to insure adequate and feasible capital structures; and to see that the shareholders are provided with informative periodic financial reports. The Act is long and involved, not only because it is quite detailed and specific in its requirements but also because it covers many different situations and considerations, many of which bear no relation to the Small Business Investment Companies, such as the activities of open end mutual funds, the problems involved in connection with face-amount certificate companies and periodic payment plan companies, and so on.

Although it would be unnecessary here to go into a detailed analysis of the many directives contained in the statutes and rules governing investment companies, there are some of these provisions which ought to be kept in mind. First, the Investment Company Act requires that, before a public offering of investment company securities may be made or completed, an initial \$100,000 in net worth must be raised privately or from not more than twenty-five persons as part of a public offering, in accordance with certain specified procedures. Furthermore, the Act prohibits investment

companies from changing the nature of their business or investment policies without the approval of the stockholders; bars persons guilty of security frauds from serving as officers and directors; prevents underwriters, investment bankers or brokers from constituting more than a minority of the directors of such companies; prohibits transactions between such companies and their directors, officers or affiliated companies or persons, except upon approval by the Commission; and prohibits pyramiding of such companies or cross-ownership of their securities.

These prohibitions and affirmative requirements are based upon extremely careful studies of the industry and are designed to achieve the general statutory aim of investor protection. That they have succeeded in the purpose of establishing public confidence in the investment company industry is perhaps best demonstrated by the pragmatic results. From the first year of the operation of this legislation in 1941, to the present the dollar value of investments in these concerns has grown from \$2-1/2 billion to \$16 billion, and the number of individual investors has increased manyfold.

It is our intention to mold the activities of the SEC under the Small Business Investment Act as nearly as possible to the purposes and aims of this legislation while at the same time preserving the integrity of the salutary provisions of the Acts which we administer. As I mentioned, our staff is working with the Small Business Administration to conform the pertinent rules, regulations and forms under the Securities Act for small business investment companies with those which will apply to such companies under the Investment Company Act and with the requirements of the Small Business Administration.

I think that I should also mention at this point the possible effect of the Trust Indenture Act of 1939, which complements the Securities Act and, generally speaking, requires public offerings of debt securities to be issued under a qualified indenture. I mention this, because the debentures to be issued to the Small Business Investment Company would normally be put out under a corporate indenture, there being an implicit understanding as I have previously pointed out that such securities may eventually be distributed to public holders. This caveat may be rather academic in practice, however, since the Trust Indenture Act exempts issues of less than \$1 million, and the other limitations of the Small Business Investment Act make it unlikely that a single investment under that Act will normally reach such a figure. For qualification under the Trust Indenture Act, certain required protective provisions must be included in the indenture, and there must be a disinterested trustee. The Small Business Investment Act of 1958 adds a new provision to

the Trust Indenture Act which authorizes the Commission to exempt, without limitation as to amount, any class of securities issued by a small business investment company, subject to such terms and conditions as may be prescribed. Our staff is also giving consideration to the need for, and possible extent of, an exemptive regulation under this authority.

I would like to point out that, what with the exemptive powers granted by the new Section 3(c) of the Securities Act of 1933, by Section 6(c) of the Investment Company Act and by the new provisions of the Trust Indenture 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. This is a completely new field and there is plenty of room to maneuver. However, our eventual aim is clear, and with the help of industry and the bar, I have no doubt of our success.