

11A of the Act.⁶⁴ Although each of these facilities needs refinement and continued assessment in the light of operating experience and changing economic and regulatory concerns, their initial implementation must be seen as a significant first step. Additionally, through the January Statement and the responsive commentary, during the past year the Commission and industry have had an opportunity to consider a variety of alternative national market system configurations.

In this release the Commission has set forth an updated national market system program which attempts to be responsive to the progress made and the commentary it has received during the past year while remaining consistent with objectives set forth in Section 11A(a) of the Act. We believe that the consolidated transaction reporting and quotation systems, comprehensive market linkage systems and nation-wide price protection for public limit orders will achieve certain of these Congressional objectives. However, we remain concerned that, while addressing the disclosure and market fragmentation issues raised by the Congress, the implementation of these facilities alone may not fully address the need for providing a fair field of competition among brokers and dealers and among markets⁶⁵ and thereby ultimately fail to assure that customers receive the best execution of their orders. For example, continuation of the practice of most large brokerage firms of automatically routing retail size orders to purchase or sell multiply-traded securities to the "primary" market for the security may preclude effective competition among markets despite the existence and enhancement of market linkage systems. Since it may not be possible to realize all of the objectives set forth in Section 11A of the Act at the same time or to envision a point in time after which the Commission and the securities industry will be able to state that all of these objectives have been permanently secured, the Commission believes that it must guard against a course of action which sacrifices one or more of these objectives in order to achieve others. In this light, the Commission intends to reassess its efforts and those of the industry on a continuing basis in order to assure that there is an

⁶⁴See Securities Exchange Act Release Nos. 13662 (June 23, 1977), at 22-23, 42 FR 33510, 33512-14, and 11942 (December 19, 1975), at 10-11, 41 FR 4507, 4510.

⁶⁵Section 11A(a)(1)(C)(ii) states that one objective of the national market system is "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."

opportunity for fair competition in the securities markets and specifically requests comment on the effectiveness of the proposals contained in this release in achieving this goal.

While the initiatives proposed in this status report represent the Commission's views after consideration of the progress made during 1978 and the many comments received in response to the January Statement, the Commission remains receptive to alternative suggestions, particularly alternative ways of achieving the goals articulated herein and encourages interested persons to submit commentary on any of the Commission's views expressed in this release. Comments should be addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Room 892, 500 North Capitol Street, Washington, D.C. 20549. All comments should refer to File No. S-735-A and will be available for public inspection at the Commission's Public Reference Room, Room 6101, 1100 L Street, N.W., Washington, D.C.

By the Commission.

George A. Fitzsimmons
Secretary

SECURITIES EXCHANGE ACT OF 1934
Release No. 15672/March 22, 1979

SEE

SECURITIES ACT OF 1933
Release No. 6041/March 22, 1979

SECURITIES EXCHANGE ACT OF 1934
Release No. 15673/March 22, 1979

REPORT OF INVESTIGATION IN THE MATTER OF GREATER WASHINGTON INVESTORS, INC.

I. INTRODUCTION

The Commission has conducted a private investigation of Greater Washington Investors, Inc. ("GWI") and its wholly-owned small business investment

company su
investments
standard of
of directors
Act of 1940
appropriate
be issued p
Exchange A

II. BACKG

Greater Wa
Columbia c
is registere
nondiversifi
ment type
technology-
markets exi
asset value
commencec
in 1969 and

Until July 1
under the S
that time i
owned sub
Investments
and its lic
company.

Simultane
investigatio
suspended
of GWI.
because of
valuation o
period endi
set forth i
1974, appe
questions
securities.
1974, with
sion outli
financial st

III. ISSUA

In 1968, G
notes of a
develop 2,
Coast. By
\$2.6 millio
land. The

*Commiss
of this Rel

company subsidiary, Greater Washington Industrial Investments, Inc. ("SBIC"). In light of the high standard of care to which investment company boards of directors are held under the Investment Company Act of 1940 ("1940 Act"), the Commission deems it appropriate that a public report of this investigation be issued pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act").*

II. BACKGROUND

Greater Washington Investors, Inc., a District of Columbia corporation organized on August 26, 1959, is registered under the 1940 Act as a closed-end, nondiversified investment company of the management type principally investing in unseasoned technology-oriented companies for which no active markets exist. GWI is internally managed and its net asset value has fluctuated from \$4.8 million when it commenced operation in 1960 to a high of \$21 million in 1969 and a low of \$731,000 in 1975.

Until July 1, 1968, GWI operated as a federal licensee under the Small Business Investment Act of 1958. At that time it transferred to a newly created wholly-owned subsidiary, Greater Washington Industrial Investments, Inc., certain of its assets and liabilities and its license as a small business investment company.

Simultaneous with entering a formal order of investigation, the Commission on November 7, 1974, suspended over-the-counter trading in the securities of GWI. The suspension was initiated primarily because of questions concerning the GWI Board's valuation of portfolio securities for the semi-annual period ending June 30, 1974. GWI's net asset value as set forth in its semi-annual report dated June 30, 1974, appeared to the Commission to raise significant questions as to the value of its portfolio of restricted securities. The trading ban was lifted on December 26, 1974, with an explanatory statement by the Commission outlining its concerns with the June 1974 financial statements.

III. ISSUANCE OF AN OPTION AGREEMENT

In 1968, GWI invested \$500,000 in common stock and notes of a company which owned and intended to develop 2,000 acres of land on Mississippi's Gulf Coast. By 1971 GWI had increased its investment to \$2.6 million, secured by a second mortgage on the land. The company was unsuccessful in its

development efforts and defaulted on its obligations to GWI. In contemplation of foreclosure, GWI formed a wholly-owned subsidiary, Singing River Properties, Inc. ("SRP") in June 1971. To capitalize SRP, GWI exchanged the second trust notes for SRP stock and debentures. Foreclosure occurred in August 1971, when SRP "bid in" the properties in cancellation of the indebtedness and took ownership of the property subject to the existing first trust notes.

In June 1972, SRP obtained a \$4.5 million loan commitment from Continental Mortgage Investors ("CMI"), secured by substantially all of SRP's assets. In addition, GWI issued CMI an option which provided that upon maturity of the loan (June 30, 1975), or prior thereto in the event of default by SRP, CMI could require GWI to repurchase SRP's note at its then current face value plus accrued interest upon 30 days' written notice.

SRP, however, was in poor financial condition at the time it received the loan commitment. It lost \$226,000 during its first six months of operation, during which period GWI and its SBIC subsidiary invested \$339,661 in demand notes and non-interest-bearing advances. A footnote to SRP's December 31, 1971 financial statements stated:

The Company's present sources of revenue are not considered sufficient to support current operations or to finance the further development of the property. In addition, the Company's resources are not sufficient to permit repayment of the \$1,200,400 first trust note if demand were made by [Bank]. Thus, the Company is in need of substantial additional financing and is presently dependent upon its parent company, [GWI], to provide the necessary funds. [GWI] has indicated its intention to continue to provide additional funds until other financing is obtained. However, the extent to which funds will continue to be provided cannot be presently determined. Management of the Company and of [GWI] are currently attempting to secure additional financing to provide necessary working capital to permit further development of the property and to refinance the first trust note.

In their report letter, SRP's independent auditors further stated:

This situation raises a question as to whether or not the going concern basis is an appropriate basis for these financial statements. If substantial additional financing is not obtained, or if the parent

*Commissioner Karmel dissents from the publication of this Release.

company discontinues providing funds, the Company may be unable to continue its operations.

For these reasons, the auditors did not express an opinion on SRP's financial statements prepared as of December 31, 1971 for the six-month period from the date of incorporation (June 30, 1971) to December 31, 1971.

SRP continued to lose money in 1972 (\$165,897 for the first six months), and by June 30, 1972, GWI had advanced an additional \$276,396.

The CMI loan to SRP was approved by the Continental Advisers loan committee in May 1972, subject to several conditions, one of which was that

[a] complete financial analysis by [a vice-president and treasurer of Continental Advisers and assistant treasurer of CMI] be conducted of [GWI], the parent company and such analysis and recommendations be reviewed by the Loan Committee as a condition precedent to the documentation of this loan. This is important in that [GWI] will provide a repurchase agreement to CMI, which repurchase agreement shall provide for the purchase of CMI's note either upon default or upon maturity.

That report states:

The specific purpose of the review was to determine whether [GWI] appeared to have the financial strength necessary to honor an agreement to repurchase the subject loan at the end of three years if the loan is not paid by its terms. In addition, attention was directed to the fact that it would be necessary for [GWI] to provide [SRP] with funds to service debt and provide marketing support during the second and third years of the subject loan program since such costs were built into the loan for only the first year.

[GWI's president] has assured me that SRP is [GWI's] principal investment at this time and that the entire resources of [GWI] will be managed with a view of providing all the support necessary to meet the cash obligations arising from this project. He indicated that while cash flow generated from operations over the next three years would not be kept idle in order to accumulate funds against this contingent liability,

the reinvestment of such funds will be made with the view of providing reasonable liquidity on a fairly short-term basis if necessary.

The financial statements of SRP do not indicate any real potential for providing funds for debt service and marketing costs. [GWI's president] is aware of this and indicated that [GWI] has committed \$1.5 million to support SRP.

The GWI Board stated that its decision to take over the Mississippi properties through foreclosure was predicated upon its judgment, based on a November 1969 MAI appraisal of such properties of more than \$4 million and subsequent independent valuations of up to \$8 million, that they were worth substantially more than the amount invested. A \$3.6 million MAI appraisal, made immediately after foreclosure, confirmed the Board's judgment that significant values existed and established a net value of GWI's interest in excess of \$1.8 million. The GWI Board states that its decision to support SRP financially was based upon evaluations prepared by various independent consultants. In addition, the decision to take the CMI development loan commitment was predicated in part upon contemporaneous projections prepared by another consultant¹ which concluded that SRP would have been able to fully service the development loan as well as all other operating costs, including marketing. Thus, it is the Board's position that SRP was in relatively strong condition in terms of the value of its assets, and that it had a reasonable basis to conclude that SRP would be a viable operation if properly financed. The Board believes that its judgment was confirmed when SRP's auditors issued an unqualified opinion on SRP's 1972 financial statements following consummation of the CMI loan.

It is the Commission's view that where a wholly-owned subsidiary, in weak financial condition, dependent upon cash infusions from its parent to continue operations, receives a loan, the interest payments on which it cannot service and which its parent is obligated to repurchase upon default, the repurchase agreement evidences an indebtedness of the parent and is therefore a senior security within the meaning of Section 18(g) of the 1940 Act.

¹This consultant was a portfolio company in which GWI had invested \$150,000 in debentures and warrants. In addition, it had a consulting contract with SRP, under the terms of which it would receive a fee of 1.5% of the CMI loan.

Section 18(a)(1) securities rep percent asset of a Commis percent asset parent-only, t after \$1,625,6 loan agreeer coverage.³ H that by virt indebtedness GWI did not asset covera

²The Comm issued purs exempting G from certain relevant part

Subjec individ Newsu the as 18(a) issuan ties. SBA c time invest permi rules Wash borrc borro the S no e provi issue of s whic Grea not issu

³On July CMI loa Commis basis, w value de annual r coverag Commis determin 1974.

⁴Contin and a

Section 18(a)(1)(A) of the 1940 Act requires that senior securities representing indebtedness have a 300 percent asset coverage. In the case of GWI, by virtue of a Commission order dated July 1, 1968, a 300 percent asset coverage on a consolidated, as well as parent-only, basis was required.² On June 30, 1972, after \$1,625,640 had been advanced by CMI under the loan agreement, GWI itself had 671% asset coverage.³ However, the following figures indicate that by virtue of SBIC's previously outstanding indebtedness to the Small Business Administration, GWI did not, on a consolidated basis, have 300% asset coverage:⁴

Total Assets	Total Senior Securities	Asset Coverage
\$15,081,038	\$5,789,204	261%

It is GWI's belief, based on what it considers to be controlling authority, that the CMI transaction did not involve the issuance of a senior security; GWI states that in entering into the transaction it relied upon the considered advice of counsel to such effect.

By entering into the option agreement, the Commission believes that GWI became overly leveraged, a situation Section 18(a)(1)(A) was designed to prevent. Furthermore, the existence of the option ultimately became one of the considerations leading GWI to liquidate portfolio assets to support SRP. Failure to do so would have permitted CMI to assert a default by SRP and to trigger the option, if it so elected.

IV. THE GWI BOARD OF DIRECTORS' VALUATION OF PORTFOLIO SECURITIES

GWI is required by Section 30(d) of the 1940 Act to transmit to shareholders, at least semi-annually, reports which set forth the amount and value of securities owned. Section 2(a)(41) of the 1940 Act defines "value" to mean, with respect to securities for which market quotations are not readily available and other assets, "fair value as determined in good faith by the board of directors."

Both Accounting Series Release ("ASR") 113 (October 21, 1969) and 118 (December 23, 1970) state that as a general principle, the current "fair value . . . would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale." The AICPA Audit Guide for Investment Companies defines "current sale" to mean "an orderly disposition over a reasonable period of time."

In an effort to insure that its valuations met the statutory test of good faith, the GWI Board of Directors stated that it valued its restricted securities in good faith by using "benchmarks" such as cost, market price, the price of a third-party transaction, or estimated realizable value. GWI believed that its valuations met the AICPA test of "orderly disposition

greater deficiencies in asset coverage during the years 1972, 1973 and 1974. Thereafter SRP failed to make the interest payments required by the loan. In December 1975 the loan was modified to eliminate a need for interest payments other than from the proceeds of property sales, and CMI agreed to cancel the option agreement upon the investment of GWI of an additional \$600,000 in SRP over a stipulated period.

²The Commission's July 1, 1968 order, which was issued pursuant to Section 6(c) of the 1940 Act exempting GWI and its newly formed SBIC subsidiary from certain provisions of the 1940 Act, provided in relevant part:

Subject always to Greater Washington, individually, and Greater Washington and Newsub on a consolidated basis, having the asset coverage required by Section 18(a) of the Act immediately after the issuance or sale of any senior securities. . . . Newsub may borrow from the SBA on such basis as the SBA may from time to time lend to small business investment companies and as may be permitted under the Act and applicable rules thereunder, provided that Greater Washington will not guarantee any such borrowings by Newsub, except the borrowings by Greater Washington from the SBA initially assumed by Newsub, but no extensions or renewals thereof, and provided that Greater Washington will not issue or have outstanding any other class of senior security in the period during which such guaranty is outstanding. Greater Washington will not itself, and will not cause or permit Newsub to otherwise issue any class of senior security.

³On July 16, 1974, SRP requested its last draw on the CMI loan commitment. As of that date, the Commission believes that GWI, on a "parent only" basis, with a 287% asset coverage (using the asset value determined by the GWI Board for the semi-annual report for June 30, 1974) no longer had the coverage required by Section 18(a)(1)(A). The Commission notes that the GWI Board did not determine the June 30, 1974 asset value until July 19, 1974.

⁴Continuous borrowing pursuant to this line of credit and a decreasing asset base created greater and

over a reasonable period of time"; moreover, as the Small Business Administration states in its Valuation Guide for SBIC's, "the very nature of (venture) investments eliminates this method (valuation in terms of current sale) in many cases."

The GWI board had, with the assistance of its counsel and auditors, formalized its valuation procedures in 1963. It developed a standardized format for written valuation summaries; it established a valuation committee to review detailed information concerning each investment with GWI management quarterly and to provide recommendations to the GWI Board, and it held full valuation deliberations at board meetings which were often attended by its general counsel and independent public accountants.

Realizing that the valuation of venture-type investments is difficult and that there is no precise valuation for each investment, the Commission nevertheless considers the following valuation practices by the GWI Board to be inconsistent with statutory and regulatory requirements.

A. Valuation of Debt Instruments Without Reflecting Current Interest Rates

At June 30, 1974 GWI held 23 debt instruments consisting of notes and debentures, 19 of which were valued at cost. These debt instruments were valued at approximately \$3.2 million (cost \$3.7 million) or 33.7% of the consolidated portfolio. In addition, GWI had advanced \$972,671 to SRP, which it carried at cost and on which it accrued no interest. The interest rate on the debt instruments ranged from 6% to 15%. The rate on five of these instruments was geared to the prevailing prime rate (11.75% in June 1974). Eleven debt instruments provided a return below the prime rate and below the 12%-15% return GWI received on its 1974 investments. As interest rates rose and GWI's need for interest income increased, interest rates charged on new investments increased: some were pegged to the rapidly increasing prime rate and others carried rates substantially in excess of prime. The GWI Board of Directors, however, did not adjust the value of those debt instruments carrying interest rates below GWI's current lending rate.

GWI points out that it has consistently and publicly taken the position that the discounting of debt securities to reflect changes in market rates is an unnecessary and inappropriate refinement in the valuation of venture-type debt instruments, especially when they are part of "packages" of investments including debt and equity components. The GWI Board states that it allocated changes to the equity component first and maintained debt at cost unless equity had been reduced to zero. GWI's 1973 Annual Report to Shareholders states: "many of the debt

securities which were purchased at par and have been so valued in the portfolio are not necessarily competitively priced as an individual security. However, viewed in the context of the total financing package and the issuer's ability to repay at maturity, such valuation is considered appropriate." The same of similar statement had been made in each of GWI's annual reports since 1969. Thus, while the GWI Board separately reported its valuations of the equity and debt components of its portfolio security "packages," it states that it was effectively valuing the securities as packages, as permitted by the Audit Guide. Finally, GWI points out that if the debt instruments in GWI's June 30, 1974 portfolio had been discounted to a 12% interest rate, portfolio value would have been reduced by less than \$50,000 or 1/2 of 1% of portfolio value.

The Commission does not believe that the discounting of debt securities to reflect changes in market rates is an unnecessary and inappropriate refinement in the valuation of venture-type debt instruments. Such adjustments should have been taken into account in the valuation of these securities to give stockholders an indication of their fair value.

B. Valuation of Restricted Securities at Current Market Quotations for Unrestricted Securities of the Same Class

At June 30, 1974, GWI held securities of four companies (Solid State Scientific, Inc., Western Microwave Laboratories, Inc., Radiation Systems, Inc., and Comtel Corporation), which in the view of the Commission were restricted securities, and which also had markets for unrestricted securities of the same class. Radiation Systems and part of the Solid State stock were acquired pursuant to Section 4(2) of the Securities Act. The Western Microwave stock was acquired pursuant to Section 4(1). The Comtel stock was acquired pursuant to Section 3(a)(10) of the Securities Act when the Company emerged from bankruptcy. The remaining Solid State shares were acquired pursuant to Section 3(a)(9) of the Securities Act when GWI converted debentures which it had previously received in a private placement. The GWI Board of Directors valued these securities at the "market price"⁵ for unrestricted securities of the same class, and they constituted approximately 15% of GWI's total investment portfolio. No discount from such market price was taken to adjust for any diminution in value resulting from the restrictive feature.

⁵The Board determined the "market price" of GWI's restricted equity securities having an over-the-counter market for unrestricted securities of the same class on

ASR 113 stat
at the marke
the same c
situations, b

While the po
by the GWI E
1974, the GV
not "restric
113, that e
portfolio sec
accordance v
release and c
the requirem
court-approv
these securit
that the valu
of "bid" an
discount from
stock deeme
been discour
from market
would have t

In the Comm
valued as su
were "restric
ASR 113 bec
public for sal
Securities Ac
for which the
of the same
appropriate s
not consist
fact are disc
Commission
exists which
general rule
feature.

C. Failure of Securities of Restricted Securities

1. Singing F

the basis of t
without dimi
118 would t
within the ra
best to rep
including the

⁶These secur
and in part w
Rule 144.

at par and have been
are not necessarily
individual securities
of the total financing
to repay at maturity
appropriate." The same
made in each of GWI's
s, while the GWI Board
ons of the equity and
io security "packages"
valuing the securities
e Audit Guide. Finally,
n instruments in GWI's
ould have been reduced
1% of portfolio value.

It is believed that the
to reflect changes in
ary and inappropriate
of venture-type debt
ts should have been
ion of these securities
on of their fair value.

Securities at Unrestricted

and securities of four
ntific, Inc., Western
, Radiation Systems
which in the view of
l securities, and which
cted securities of the
and part of the Soli
uant to Section 4(2)
Microwave stock was

(1). The Comtel stock
ction 3(a)(10) of the
npany emerged from
lid State shares were
(a)(9) of the Securities
entures which it had
placement. The GWI
ese securities at the
ted securities of the
ed approximately 15%
olio. No discount from
n to adjust for any
from the restrictive

market price" of GWI's
ng an over-the-counter
is of the same class of

ASR 113 states that "valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper."

While the portfolio securities in question were valued by the GWI Board as restricted securities at June 30, 1974, the GWI Board contends that they in fact were not "restricted" securities within the meaning of ASR 113, that even if ASR 113 were applicable, the portfolio securities were valued at their fair value in accordance with the "inherent worth" standard of that release and otherwise were valued in accordance with the requirements of ASR 113; and that there is a court-approved Commission precedent for valuing these securities at market. In addition, GWI contends that the valuation at market "bid" rather than the mean of "bid" and "asked" effectively represented a discount from "market price". Finally, even if all the stock deemed "restricted" by the Commission had been discounted by 25% from market "mean" or 20% from market "bid," the diminution of portfolio value would have been less than 3%.

In the Commission's opinion the restricted securities valued as such by the GWI Board at June 30, 1974, were "restricted" securities within the meaning of ASR 113 because they "[could] not be offered to the public for sale without first being registered under the Securities Act of 1933."⁶ Valuing restricted securities, for which there is a market for unrestricted securities of the same class, at "inherent worth" is not the appropriate standard for valuing such securities and is not consistent with ASR 113, unless the securities in fact are discounted from "market price." Nor does the Commission believe that a "most unusual situation" exists which would justify a departure from the general rule requiring a discount for the restrictive feature.

C. Failure to Adjust the Valuation of Securities of Companies Which Experi- enced Serious Financial Problems

Singing River Properties, Inc.

the basis of the average "bid" price for such securities without diminution for their restrictive feature. ASR 113 would have permitted GWI to use valuations within the range of bid and asked prices considered best to represent value in the circumstances, including the mean of bid and asked prices.

These securities in due course could properly be, and in part were, sold without registration pursuant to Rule 144.

At June 30, 1974, the GWI Board of Directors valued its investment in SRP at \$1,429,150, which represented approximately 15% of the value of GWI's consolidated portfolio. A \$396,700 debenture and \$972,671 of non-interest-bearing advances were valued at cost. Three million dollars of equity was valued at SRP's net book value of \$59,779, or 2% of cost. SRP operating losses were directly reflected in writedowns of the equity. The Board of Directors stated that it believed that in spite of SRP's mounting losses (\$226,000 in its first six months of operations; \$346,733 in fiscal 1972; \$1,008,793 in fiscal 1973; and approximately \$564,528 the first six months of 1974), SRP's real estate assets had substantial value and justified their June 30, 1974 valuation since the earlier appraised values were directly reduced by the amount of these losses.

SRP had its best year in 1972, with progress being made in developing the Mississippi property. The Evaluation Committee of the GWI Board of Directors asked that an appraisal be made of SRP's assets as of December 31, 1972. The \$6 million appraisal confirmed the progress that had been made and formed the basis for the December 31, 1972 valuation. However, this progress was abruptly halted the following year as was described in GWI's 1973 Annual Report to Shareholders:

At this time a year ago we were very encouraged by having sold 58 St. Andrews lots during 1972 (more than twice the number sold during the project's entire previous history), by the preliminary interest shown in the rental townhouses, and by the agreement we had reached with the local builder for joint development of Pinehurst. However, today we are almost equally discouraged by 1973's lack of continuing sales and rental momentum (with significant overbuilding in the Gulf Coast area, only 8 St. Andrews lots were sold during the year and Golfing Green is still over 60 percent unrented), by having to introduce the Pinehurst development without the assistance of a joint-venture partner and under depressed local housing conditions, and by the unreasonably high interest cost we have experienced as a result of the prime rate's 67 percent increase during the year.

GWI's ultimate recovery on its SRP investment depends on many complex factors, but sales rates and interest costs are two of the most significant. In 1971, shortly after foreclosure, a professional market study projected a local sales potential sufficient to enable GWI to recover its

investment over about an eight-year period. A similar study completed in 1973 has significantly reduced the earlier market projection, while actual experience during the year fell far short of even this reduced level. Unfortunately, at the same time as the forecast of sales rates had been reduced, the prime interest rate has climbed to an unprecedented level resulting in a rapid escalation of SRP's interest costs during 1973. While the resurgence in housing demand which has been experienced on the Gulf Coast in recent weeks and the current indications of lower prime rate offer encouragement, we must assume that SRP will continue to require the major portion of GWI's resources for the foreseeable future.

A new appraisal was not obtained. Instead the GWI Board valued the investment at its net book value, which was derived from the foreclosure appraisal and reduced by subsequent operating losses. This represented a write-down on the investment of \$1,661,756 during 1973. In October 1973, the Internal Revenue Service disallowed SRP's claimed losses on the foreclosure and appraised the properties at a valuation of \$524,000 greater than the \$3.6 million MAI appraisal previously relied upon by GWI as the basis from which all subsequent SRP valuations were derived. The GWI Board was aware of and considered the impact of such appraisal on the earlier appraisals.

That the market value of SRP's assets at December 31, 1973 and June 30, 1974 may have been considerably less than that at which they were carried on the books of SRP is suggested by GWI's failure to attract a purchaser for the property. Beginning in January 1974, GWI actively sought to find a purchaser or joint venturer for SRP. Only one company was found which expressed interest in the project; however, the president of that company told the Commission staff that he was not seriously interested in the project at all. He recalls having gone to Mississippi to see the property, but said it had major problems and discussions never became serious. Nonetheless, the GWI Board states that it had been advised and believed at the time of the June 30, 1974 valuation that there was serious interest in a joint venture whereby the subject company would take over management and marketing at SRP and arrange any needed financing. Subsequent to the June 30, 1974 valuation, GWI was informed by letter dated July 22, 1974 that although the company's management "truly had an interest in pursuing" an involvement in SRP when GWI's management had visited them in June, a subsequent resignation by the company's vice president of marketing had precluded that possibility. In short, GWI could find no one interested in

purchasing the property at the \$1.4 million at which it was valued by the GWI directors at June 30, 1974.

Although it appears that the GWI Board was looking to a viable medium-term work out of the SRP project, the Board was aware in December 1973 that prospects for such a work out were dim. In a confidential memorandum prepared for the December 14, 1973 Board of Directors' meeting, GWI's president analyzed GWI's present status and the implications for its future considering recently completed SRP cash flow projections. According to these projections \$600,000 to \$840,000 was needed for SRP for the year ending September 30, 1974. GWI's own operating expenses were running \$25,000 per month or \$300,000 a year. To meet these needs, GWI had \$300,000 in cash, an additional \$250,000 which could be raised from the sale of freely traded securities and, at current market, \$385,000 from the sale of Solid State shares pursuant to Rule 144. GWI's president made it clear that after mid-1974, the sale of Solid State shares would represent the only real source of funds to meet the cash flow requirements. The stock was then trading at \$13 3/4 per share. The memorandum stated:

To meet our future needs assuming SRP requires \$4.5 million through 1977, and GWI's operating requirements average \$250,000 per year . . . Solid State [shares] would have to be sold for \$5 million . . . or an average of \$50 per share. While this price is at least possible in terms of some analysts' estimates of the company's prospects, we will run the risk of both general market conditions and Solid State's own operating performance during the intervening years. Clearly, GWI *must* develop alternative sources for financing SRP's needs. (Emphasis in the original)

This cash flow analysis makes clear the likelihood, eventually borne out, that GWI would be unable to continue to support SRP, resulting in an event of default on the CMI loan.

In January 1974, GWI's president prepared another memorandum to the Board to facilitate its valuation of the SRP investment. Appendix A thereto presented a modified five-year CMI work-out analysis, which projected that with an additional \$2 million investment by GWI, and CMI forgiveness of all future interest, the CMI loan would be repaid in full at the end of 1977 (three years after the original maturity date of the loan). The total value of residual property would be \$4.4 million, more than enough to recover the \$2 million additional investment and to support the \$1.4 million valuation the Board placed upon its investment at December 31, 1973.

Hc
as
the
the
ma
by
tha
for
picl
inve
ass

GW
its
firs
197
reas
30,
anal
prep
prot
outc
basi

At
reco
and
whic
rates
burdi
cash
REIT
going
partn
intere
const
SRP's
ment
report
accele
the p
quality
chara
includ
at 2,0C
area
expan
progra
that a
approp
strateg
costs
funds
partner
observe
priced
market
report
standar

However, there were problems with most of the assumptions of this analysis, which had manifested themselves by June 30, 1974. In short, by June 1974 the Board of Directors was aware of information which made it unlikely that the work-out analysis prepared by GWI's president in January 1974 was viable, and that a more realistic analysis, which assumed no forgiveness of CMI interest, painted a very bleak picture: GWI would be unable to recover any of its investment after five years of selling most of SRP's assets.

GWI points out that it had decreased the valuation of its equity investment in SRP by \$564,528 during the first half of 1974 and by \$2,226,284 since June 30, 1973; the Board states that it believes that this reasonably reflected the SRP deterioration as of June 30, 1974, based on facts then known. As to the analyses, the Board's position is that they had been prepared to stimulate the Board's thinking about the problem; none was ever claimed to be the probable outcome; and none ever formed the sole and explicit basis for an SRP valuation.

At June 30, 1974, the GWI Board states that it recognized that property sales lagged expectations and that a significant negative cash flow continued which was aggravated by rapidly accelerating interest rates. Although the latter represented a serious burden, GWI was advancing the funds to cover SRP's cash needs, including interest payments on the two REIT loans, intending to maintain the project as a going concern. The effort to find a joint venture partner had resulted in one serious expression of interest believed to be viable at June 30, 1974. Also, consultants who had been commissioned to evaluate SRP's potential as a second home/recreation/retirement project gave encouragement in a June 15, 1974 report that this offered a viable alternative for accelerating property sales. Their report stated that the project "presents a very competitive face. The quality of the site planning and physical layout, the character and finish of the principal amenities including the golf course, and the overall project scale at 2,000 acres make it unique in the immediate market area . . . it could form the solid base for any expanded project concept and merchandising program." The report went on to suggest, however, that a further study should be done to develop appropriate sales targets, establish a marketing strategy and evaluate sales cost efficiency since such costs could be substantial. (GWI did not have the funds needed and was looking to a joint venture partner to provide them.) In addition, the report observed that SRP's existing product offerings were priced at or near the top end in the single family sales market in the Biloxi-Pascagoula market; however, the report goes on to state that they "established the standard of quality and value in the immediate market

area." Under these circumstances, valuation at a level which depreciated the SRP investment by nearly \$3,000,000, which represented a 67% diminution from cost, was deemed appropriate by the Board.

Furthermore, in allocating a valuation among the investment elements of the package, GWI's procedure was to apply the depreciation first to the most junior securities and only when it exceeded their cost was it allocated to the debt elements. The SRP investment package consisted of common and preferred stock, a convertible debenture (held by the SBIC) and cash advances. In determining and allocating the valuation of this investment, the Board of Directors states that it relied primarily on the equity book value, after operating losses and write-down of assets to net realizable value. Consequently, at June 30, 1974 the \$3 million of SRP common and preferred stock which GWI held was written down by \$2,940,221, or 98 percent, while the debt elements aggregating \$1,369,371 were left at cost.

The GWI Board, with the 67% write-down of the investment package, valued its investment in SRP at \$1.4 million at June 30, 1974. The Commission believes that the GWI Board of Directors was aware of information which called into question the previously appraised value of SRP's assets, that management was having serious problems in trying to interest other developers in purchasing SRP, that GWI was experiencing a severe cash flow problem which made its continued payment of SRP's debt service doubtful, and that management's own long-term work-out analysis indicated little likelihood GWI would recover anything on its investment in SRP. Under the prevailing conditions, the Commission believes that the GWI Board's valuation of the investment at \$1.4 million at June 30, 1974, which included the valuation of SRP's debt instruments at cost, was overly optimistic and underestimated the realities of the SRP situation; and that the Board cannot rely on a benchmark such as cost in the valuation of the debt component of the investment, notwithstanding the write-down of the equity component, when there are clear indications that there has been a substantial change in the affairs of the issuer.

2. International Management Services, McKee—Berger—Mansueto, Inc. (IMS/MBM)

At June 30, 1974, the GWI Board of Directors valued its investment in IMS/MBM (a \$150,000 note, a \$200,000 note and \$363,150 of common and preferred stock) at cost: \$713,150, approximately 7.5% of the value of GWI's consolidated portfolio. MBM provides construction project management services. It was acquired in 1972 by IMS, a company which provided consulting services in marketing, radio and television and which owned interests in hotels and radios

stations in the Middle East. No interest payments had been made on either note since they were issued in 1972. The parent company, IMS, suffered severe cash flow problems and preliminary 1973 consolidated figures available to the GWI Board of Directors in June 1974 indicated a \$788,000 loss. In addition, IMS had failed to produce reliable financial statements. IMS was highly leveraged with a deficit working capital position and a deficit in tangible net worth. It had consistently failed to meet earnings projections. The \$788,000 loss reported in June 1974 was in contrast to the \$440,000 profit which had been projected. The Board of Directors has stated that it weighed these negative factors against certain positive considerations, among which were the following: advice from IMS management that IMS was seeking additional financing through sales of assets and the issuance of securities, and that IMS was believed to be in an exceptionally good position to benefit from rapidly developing oil wealth and had a pre-eminent reputation in Middle East market consulting as well as in construction project management through MBM. The Board further states that IMS also had a proven capability in hotel management and media operations, which were potential growth areas in the Middle East. This included a 20-year exclusive franchise to operate a commercial radio/television station in Bahrain, which would cover Saudi Arabia as well. MBM was reporting good sales and earnings, but this was in the context of a consistent failure to produce reliable financial statements and to meet projections. In 1973 it had won major fee-generating projects from the Chicago Board of Education and in Puerto Rico. IMS had also arranged bank borrowings of approximately \$1,500,000 in 1973, and obtained a \$729,000 equity private placement from six individuals, including a close friend of an IMS principal at a price in excess of GWI's valuation. In 1974 IMS borrowed an additional \$150,000, but was having substantial trouble raising additionally needed funds. Accordingly, the GWI Board states that it determined that the positive and negative factors were sufficiently balanced that valuation at cost was appropriate.

The Commission believes that the Board of Directors, in valuing its IMS/MBM investment at cost, placed too much emphasis on anticipated operational and market developments and proposed additional financing, and considered sales of securities to friends of management as an accurate reflection of the value of GWI's own investment. The Commission believes that the valuation should have given more consideration to the hard economic realities of the IMS/MBM situation, including substantial losses, unreliable preliminary financial statements, deficit working capital position, a deficit net worth, a severe cash shortage, unrealized projections and the fact that there had been no payment of principal or interest on

the debt securities since their issuance in December 1972.

V. DISCLOSURES IN STOCKHOLDER REPORTS

Although it does not appear that the GWI Board of Directors decided to stop funding SRP's payment of CMI interest until September 1974, thereby creating a basis for default on the loan obligation which would allow CMI to exercise its option, both the 1973 Annual and 1974 Semi-Annual Reports by footnote and letter to shareholders mention such a possibility. Because default was a distinct possibility, the Commission believes that disclosure of the distress value of GWI's portfolio, similar to that undertaken in an internal memorandum of September 14, 1974 to the Board by GWI's president, should have been made. The memorandum estimated that GWI's consolidated portfolio, excluding SRP, could be liquidated on an immediate sale basis for only \$2.4 million, which would have been insufficient to cover the \$2.9 million obligation on the option in December 1973 or June 1974.

GWI points out that the \$2.4 million "distress value" of the portfolio was actually the rough estimate by GWI's president of the cash resources that might be generated under one particular alternative for dealing with the CMI contingent liability. It assumed that SRP, whose net assets then actually exceeded the CMI obligation by over \$900,000, was given to CMI in partial settlement; consequently, the remaining contingent obligation would have been significantly less than \$2.9 million. Furthermore, except for one private holding which was reduced to its cost, it actually valued all of the portfolio securities at the equivalent of their June 30, 1974 valuations rather than on a distress sales basis; the additional reduction from the reported June 30 net asset value was due simply to the arbitrary assumption that the SBIC was sold intact for 37 percent of its June 30 valuation which reflected the average discount from net asset value at which public SBIC's were then trading.

The Board believes extensive disclosure of the possible impact of the option on the company had been made in GWI annual reports and that the stockholders' understanding of that disclosure is reflected by the fact that the over-the-counter market "bid" price of GWI shares in November 1974, when the Commission suspended trading, was a mere \$1/8 bid, or 2-1/2 percent of the June 30, 1974 net asset value. GWI had included the full audited SRP financial statements, including the auditors' qualification that SRP's sources of revenue were not considered sufficient to support operations and permit payment of interest and principal on notes payable, in its 1973 Annual Report to Shareholders, and included condensed interim financial statements in its June 30,

1974 Semi-Annual Report. The Board's letter to shareholders identified the distress value of the option as the uncertainty of the SRP's payment. The SRP ceased payments in October 1974, creating the basis for the extensive additional disclosure in the October Newsletter, pointing out the approach [to valuing] net asset value as being imprecise that in error in one Board was info staff level, cooperative arrangements, thus in judgment, any

Another problem with disclosures in Annual Reports is delinquencies in securities of public

GWI points out that it conditionally has to deal with equity payments on investment. The overdue is one factor on the Board in valuing the factor out for the Board concludes that the immediate collection of securities is unnecessarily complicated, a Subsequent to general counsel's such informal discussions the GWI Board believes that these matters should be handled by auditors, who should follow procedures as an exception to such any valuation that its disclosure

The Commission's closure should be better justified

VI. CURRENT DISCLOSURE

As a result of the time since the disclosure described here

1974 Semi-Annual Report. In addition, the shareholders letter which was incorporated in each report identified the detailed problems which SRP faced and the uncertainties which the option presented. When SRP ceased paying interest on its CMI loan, thereby creating the basis for a potential default, GWI made extensive additional disclosure of the situation and its possible impact on the company in a September-October Newsletter sent to GWI shareholders and the press, pointing out that "if a totally pessimistic approach [to valuation] were taken, essentially a zero net asset value would result" and "any valuation yielding a net asset value above zero would be so imprecise that it easily could be several million dollars in error in one direction or the other." Further, the Board was informed by GWI's president that CMI, on a staff level, had expressed willingness to be cooperative and work with SRP in solving its problems, thus rendering unlikely, in the Board's judgment, any attempt by CMI to exercise the option.

Another problem the Commission has with disclosures in the 1973 Annual and the 1974 Semi-Annual Reports is the failure to disclose delinquencies in interest and principal payments on securities of portfolio companies.

GWI points out that its venture investments traditionally have been interrelated packages of securities with equity participation the principal reason for the investment. The fact that such collections may be overdue is one of the many considerations for the GWI Board in valuing portfolio investments. Singling this factor out for special reporting, particularly when GWI concludes that it is not in its interest to pursue immediate collection, could be misleading and might unnecessarily affect adversely the particular portfolio companies, and hence, GWI's investment in them. Subsequent to initiation of the investigation, GWI's general counsel advised specifically against including such information in GWI's shareholder reports. The GWI Board believes that the disclosures concerning these matters were adequate. It notes that its outside auditors, who annually reviewed GWI's accounting procedures and underlying documents, did not take exception to such procedures or documentation nor to any valuation in the 1973 Annual Report, and believes that its disclosures were customary for the industry.

The Commission nevertheless believes that such disclosure should have been made so that investors could better judge the quality of their investment.

VI. CURRENT STATUS OF THE MATTERS DISCUSSED HEREIN

As a result of the passage of a substantial amount of time since the 1972-74 period when the matters described herein occurred, the Commission believes

that it is appropriate also to report the current status thereof. To this end, GWI has assured the Commission that, it is in compliance with the views of the Commission expressed herein to the extent that they are currently applicable.

With respect to the Commission's views on Section 18 of the 1940 Act, the matter is now moot since, as a result of GWI's June 30, 1978 reorganization as a federally licensed Small Business Investment Company, it is now statutorily exempt from the asset coverage requirements of Section 18(a)(1)(A) of the 1940 Act.

Concerning the evaluation of portfolio securities, GWI has advised the Commission that it has formally adopted policies with respect to adjusting its valuations of debt securities to reflect changes in market interest rates and, consistent with its statutory duty to determine "fair value," discounting "restricted securities" from market. At June 30, 1973, GWI held only one debt security with an interest rate below 12%; it was valued at a 26% discount from its face amount. This affected portfolio value by 0.2%. GWI held only one "restricted security" at June 30, 1978 which was valued at cost, representing a 23% discount from market. This affected portfolio value by 0.5%.

Finally, with respect to the Commission's views on the disclosure of delinquencies in principal and interest payments, GWI reports that commencing with its June 30, 1978 report to shareholders, any such delinquencies are being noted.

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 20965/March 21, 1979

In the Matter of

GENERAL PUBLIC UTILITIES CORPORATION
Parsippany, New Jersey

(70-5920)

ORDER AUTHORIZING AMENDMENT TO BANK
LOAN AGREEMENT

SEC DOCKET/49