NEWS

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THE SEC'S RECENT INITIATIVES TO FACILITATE CAPITAL FORMATION -- HELPING SMALL BUSINESS IN A BIG WAY

An Address by

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It is a great pleasure for me to be here today and to have the opportunity to discuss some of the recent SEC initiatives with respect to facilitating capital formation. One of our major efforts in this area has addressed the needs of start-up ventures and small businesses in general. As we all know, these businesses have long been recognized as serving a vital function in our economy by stimulating investments with rapid and substantial growth potential, by providing goods and services that cater to the needs of surrounding communities and by developing important technological innovations. Because of the significance of new ventures to the economic well being of our country, it is essential -- especially in today's recessionary environment -- that these businesses have access to, and the ability to raise, much needed capital for their development, sustenance, and expansion.

In this regard, the role of venture capitalists in fostering the growth and development of new businesses cannot be overstated. For as you well know, the survival of many of these businesses is dependent upon the infusion of capital from venture capital firms. This dependency is particularly acute at the present time, as a result of a depressed new issue market and high interest rates that make bank financing prohibitively expensive.

Fortunately, the venture capital industry is vibrant and growing. Currently, there are approximately 150 venture capital firms, 300 small business investment companies backed

by the Small Business Administration, and numerous bank affiliated and other corporations that search for investments in new businesses. In fact, last year, a record $1.5 billion of venture capital was invested in this country's small businesses -- twice the amount of the previous high in 1969. The Economic Recovery Tax Act, by reducing the maximum capital gains tax from 28% to 20%, will provide an additional inducement for venture capitalists to invest in small business, and hopefully will result in another record year.

This period of record high investment by venture capital firms, however, may not necessarily bode well for all fledgling businesses. For example, with respect to investments in start-up companies, high technology firms appear to be attracting the bulk of venture capital. Thus, it is possible that the future Genentechs and Apple Computers will continue to be the top draw, and will result in a diversion of substantial capital away from other deserving businesses engaged in important industrial segments of our economy.

In addition, it appears that many veteran venture capitalists consider the current crop of new businesses unusually risky enterprises, in part because last year's record high investments captured the most promising new ventures. As a result, many venture capitalists are becoming increasingly selective in the commitment of resources to these more speculative investments. Indeed, as a result of the present state of our economy, we are told that venture capital firms are pouring their funds into established

businesses in which they already have an interest, rather than start-up situations, in an effort to protect their existing investments from the throes of bankruptcy.

If this current investment pattern were to continue, many new businesses in non-technological endeavors and other existing enterprises could be deprived of the capital needed for survival.

I do not believe, however, that the efforts of venture capitalists should be the only support and incentive for the development of start-up companies and small businesses in general. Rather, in light of the importance of these enterprises to the nation as a whole, I believe that other incentives should be created to encourage entrepreneurs to expand their efforts in this area. Such incentives are particularly important today, when the current economic climate would give pause to any reasonable businessperson thinking about beginning a new venture.

For example, the present recession, which seems to invite greater numbers of business failures each day, makes starting a new business a particularly risky proposition. Dun & Bradstreet estimates that in 1982 business failures will climb to approximately 26,800 -- 10,000 more failures than in 1981, and that small businesses will undoubtedly account for most of these downfalls. In addition, the cost of starting a new business has more than doubled since 1975 to a record average $2.5 million. Inflation and high

interest rates also make it exceedingly more costly to maintain the operations of a small business.

One important incentive to induce American entrepreneurs to seek the necessary funds to start-up and expand new businesses is to reduce the cost of raising capital. For instance, eliminating the burden of registering securities offerings with the SEC could be such an incentive. In this regard, the Commission recently studied certain offerings by small businesses and found that the average expenses of issuing and distributing securities in registered offerings was more than five times as great as comparably sized unregistered offerings -- 13.9% of the offering value versus 2.4% -- an appreciable difference.

In recognizing the importance to small business of less costly financing techniques, I fully supported the Commission's recent efforts in adopting Regulation D, which is probably the most important Commission initiative designed to aid small businesses in the capital formation process. Basically, this regulation provides various exemptions from the registration requirements of the Securities Act of 1933 ("Securities Act"), for issuers making limited and private offerings of securities.

The Small Business Investment Incentive Act of 1980 ("Small Business Act"), which many of you helped formulate, laid the ground work for Regulation D. This Act in part authorized the Commission to exempt from registration

offerings of up to $5 million, in an attempt to reduce costs for small businesses.

In response to the Congressional objectives underlying the Small Business Act, the SEC adopted Regulation D in March of 1982. This Regulation restructures the Commission's registration exemptions for limited and private offerings made pursuant to Rules 240, 242 and 146 under the Securities Act, with a view toward achieving four goals.

First, the Commission aimed to clarify and simplify the registration exemptions for limited and private offerings. Second, the Commission wanted to expand the class of eligible issuers and increase the dollar amount of securities qualifying for these exemptions. Third, the Commission sought to enhance the use of these provisions by achieving a greater degree of uniformity between the federal and state registration exemptions. Fourth, and perhaps most importantly, the Commission attempted to substantially reduce the costs and burdens associated with the capital formation process.

At the risk of being somewhat technical, I would like to highlight some of the major provisions of Regulation D. The Regulation consists of Rules 501 to 506. The three registration exemptions, which became effective on April 15, are embodied in Rules 504, 505 and 506. These exemptions will replace Rules 240, 242 and 146, which will be rescinded on June 30.

Rule 504 is designed to impose only the most minimal federal regulation on "_de minimus_" offerings of securities,

that is -- offerings which do not exceed $500,000 in any 12 month period. These offerings are felt to be more appropriately regulated at the state level. In this regard, no specific federal disclosure requirements are mandated.

In addition, the Rule eliminates prior restrictions prohibiting the payment of commissions and similar transaction-related fees to persons selling the issuer's securities. Thus, Rule 504 will now allow professionals to provide much needed technical assistance to small issuers that are unsophisticated in the methods of raising capital, without depriving these issuers of their exemption from registration.

Similarly, Rule 504 provides an exception to the restrictions prohibiting advertising and resale of securities, where the offerings are made exclusively in states that require registration and the delivery of a disclosure document.

Lastly, it should be noted that because Rule 504 offerings are geared to small start-up companies seeking venture capital, the rule is <u>not</u> available to either investment companies or companies reporting under the Securities Exchange Act.

In sum, Rule 504 will enable small businesses to raise up to $500,000 with minor federal regulation. Thus, the rule promises to be a clear and workable exemption for limited offerings by small issuers regulated primarily by state "Blue Sky" laws.

The second Regulation D exemption, Rule 505, exempts from registration, offerings of securities made to an unlimited number of accredited investors, plus 35 additional persons.

As you may know, the term "accredited investor" is not new. The concept, which was used in a rule prior to Regulation D, is that certain classes of purchasers are thought to be able, because of their financial condition or expertise, to fend for themselves, and accordingly do not need the protections provided by the registration process. These classes traditionally included certain institutional investors such as banks, insurance companies, registered investment companies, employee benefit plans, and small business investment companies licensed by the SBA.

The registration exemption has been broadened under Rule 505 by the addition of several new categories to the definition of accredited investor. This expansion of categories is important because securities may be sold to an unlimited number of accredited investors under Rule 505, and as I will soon discuss, also under Rule 506.

Significantly, private business development companies, which are closely held companies that provide "significant managerial assistance" to small business, have been added, as well as large tax-exempt charitable organizations.

In addition, the term accredited investor has been broadened to include natural persons who have a net worth of $1 million or whose annual income was at least $200,000 in each of the last two years, and has a reasonable expectation that such earnings will continue.

The term also now includes those persons who purchased at least $150,000 of the securities being offered without

regard to their earnings, so long as the total price does not exceed 20% of their net worth.

Another addition to the definition is the inclusion of general partners of the issuer as well as directors and executive officers of general partners.

The acceptable method of payment by all of these purchasers has been broadened to include marketable securities, along with the previously acceptable use of cash or a cancellation of indebtedness.

In addition to an expanded definition of accredited investor, the amount of securities that can be sold in a Rule 505-type of limited offering has been increased from $2 million within six months to $5 million within twelve months. In addition, the class of issuers that can utilize this exemption has also been expanded to include limited partnerships and entities engaged in the oil and gas business.

In sum, Rule 505 enables an issuer to raise up to $5 million in a 12 month period by selling securities to an unlimited number of accredited investors, plus 35 other persons, without any need for registration with the SEC.

Rule 506 is the last of the three exemptions under Regulation D. This Rule is a safe harbor under the Section 4(2) private placement exemption to the Securities Act.

Rule 506 is basically an improvement on old Rule 146, which most members of the financial community and the securities bar found particularly unworkable, or at least unwieldy. Under Regulation D, a Rule 506 offering can be made to an

unlimited number of accredited investors, plus 35 sophisticated investors. Sophistication used to be defined as those capable of evaluating the merits and risks of an offering and who were able to bear the attendant economic risks. This is what we used to call the "rich and smart" test. Now, under Rule 506, a sophisticated person need only be smart. This Rule differs from Rule 505 in that the 35 purchasers under Rule 505 do not have to be sophisticated. The benefit of Rule 506, however, is that an unlimited amount of capital may be raised, whereas under Rule 505 there is a $5 million limitation.

Another significant point is that Rule 506 speaks in terms of actual purchasers rather than offerees which had been the case under Rule 146.

In sum, Rule 506 allows an issuer to raise an unlimited amount of funds by selling to an unlimited number of accredited investors plus 35 sophisticated persons.

There are three additional rules in Regulation D, Rules 501 to 503, that should be mentioned. These rules are applicable to all three registration exemptions. They, for the first time provide uniform definitions and common restrictions relating to, among other things, the manner of the offerings and the resale of securities. They also include a safe harbor pertaining to the integration of offerings, which basically provides that all offers and sales that take place at least six months prior to the start, or six months after the completion of a Regulation D offering, will not be considered part of

the offering. The rules also contain a uniform notice-of-sale provision, which must be filed with the Commission 15 days after the first sale in any Regulation D offering.

Of primary importance, Rule 502(b) contains the informational requirements of Regulation D, which are generally geared to the type of issuer and the size of the offering.

With respect to any offerings made under Rule 504 -- the de minimus offering exemption -- or offerings made solely to accredited investors under Rule 505 and 506, Regulation D does not mandate any disclosure requirements.

On the other hand, if offerings made pursuant to Rule 505 and 506 include purchasers who are not accredited investors, the disclosure requirements depend upon whether the issuer is a company that files periodic reports with the SEC.

If the issuer is a reporting company under the Exchange Act, the information requirements are the same regardless of the size of the offering. Such issuers may provide either of two forms of information. The issuer may provide its most recent annual report sent to shareholders, definitive proxy statement filed in connection with that annual report and, if requested by the purchaser, a copy of the issuer's Form 10-K. In the alternative, the issuer may provide the information contained in its most recent Form 10-K or in a registration statement on Form S-1 or Form 10. In addition, transactional information relating to the securities being

issued and the use of the proceeds from the offering must be disclosed.

If, on the other hand, an issuer is a non-reporting company, the information required to be provided depends upon the size of the offering. For offerings up to $5 million, the same type of information required by Part I of Form S-18, including two years of financial statements, must be provided. However, only the most recent year's financial statements need to be audited. In addition, accommodations have been made to issuers who cannot obtain audited financial statements without undue effort and expense. In these instances, corporate issuers may provide a certified balance sheet dated within 120 days of the offering. Limited partnerships may utilize audited financial statements prepared on the basis of federal income tax requirements.

For offerings by non-reporting companies in excess of $5 million, the same type of information required by Part I of a registration statement on the form that the issuer would be entitled to use, including three years of audited financial statements, must be furnished. For those issuers that cannot provide three years of audited financial statements without undue effort or expense, the rule makes allowances similar to those for offerings under $5 million.

Where offerings are made to both accredited and non-accredited investors, Regulation D requires the issuer to provide the non-accredited investor with a brief description

in writing of any written information that has been provided to an accredited investor. In addition, each purchaser may request in writing some or all of this information prior to his purchase, and must be given the opportunity to ask questions and obtain additional information from the issuer necessary to verify the information provided.

The major initiatives that I have just described under Regulation D will hopefully make it much easier, and less costly, for small businesses to use the Commission's limited and private offering exemptions, and to raise capital during this difficult economic period.

As of May 31, 1982, 201 offerings under Regulation D have already been made. The uniform notice-of-sale forms filed with the Commission indicate that 34% of the offerings have been made under the "de minimis" offering exemption, 16% under the exemption for limited offerings made to accredited investors and 35 other persons, and 40% under the private placement safe harbor. The remaining 10% have been made in reliance on more than one exemption. In addition, limited partnership offerings have outpaced corporate offerings two to one. It appears, therefore, that securities offerings under these new rules have gained broad acceptance in a short period of time.

Progress also has been made toward making Regulation D the uniform federal-state registration exemption envisioned by the Small Business Investment Incentive Act of 1980. In April of 1982, the North American Securities Administrators

Association ("NASAA") recommended to its membership adoption of a Uniform Limited Offering Exemption based upon Rule 505 of Regulation D, with certain modifications. This is quite significant because it is the first time the federal government and the states have agreed to coordinate on any kind of financial regulation.

The rules embodied in Regulation D, however, are only one aspect of the SEC's recent initiatives designed to simplify the capital formation process. Of even greater significance, perhaps, is the fact that contemporaneously with Regulation D, the Commission adopted the Integrated Disclosure System, which permits issuers offering securities under the Securities Act to incorporate by reference, into a short registration form, information already filed with the Commission under the Exchange Act. The purpose of this system is to streamline disclosure requirements and to reduce the cost of raising capital. In addition, these rules, and in particular, temporary Rule 415, the controversial shelf registration provision, attempts to facilitate timely access to the increasingly volatile capital markets.

The coordination of Regulation D with the new simplified integrated disclosure process represents a rational approach to the capital formation needs of all issuers, facilitating the ability of all companies to raise capital, whether they are in their development stages or already well established.

In addition, the Commission recently increased the asset requirements of Section 12(g) of the Exchange Act so that companies with assets of less than $3 million rather than $1 million as before, may avoid all registration and reporting responsibilities under the Act. This recent change eliminates the registration and reporting requirements for a substantial number of smaller companies.

In closing, I want to reemphasize that the SEC appreciates the vital role that new and small businesses play in the American economic system. Accordingly, it has adopted the initiatives I have discussed today in an attempt to reduce the burdens on small businesses that desperately need capital to stay afloat and to survive the potentially devastating waves of today's economy. I am certain that the SEC's efforts, in conjunction with the creativity and resolve of the venture capital industry, will help to chart a smooth course toward economic recovery for America's fledgling businesses, which in turn, will provide a major stimulus to the entire American economy.