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Attorneys at Law

January 10, 2008

Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: Definition of Eligible Portfolio Company under the Investment Company Act of 1940; File Number S7-37-04

Dear Ms. Morris:

The definition of “eligible portfolio company” under the Small Business Investment Incentive Act of 1980 (“the Act”) relies on the Federal Reserve Board margin rules that are now outdated. The Commission has proposed a rule to expand the definition, consistent with its authority under the Act, to include public companies that are below a certain market capitalization level. In this regard, the Commission is suggesting the use of a market capitalization level as a proxy to differentiate companies that have adequate access to traditional forms of capital from those that do not. The use of a market capitalization level as a proxy has been used by the Commission in other rulemaking contexts.

As the Commission finalizes this rule we thought it would useful to put market capitalization levels of 2008 into perspective as they relate to the size of public companies in 1980 when the Congress first established the definition. We also believe it is important to emphasize the general objective of the 1980 margin rules that existed when Congress established the definition in order to provide a context for adopting a final rule that modernizes the definition.

This submission: (1) explains that when Congress passed the Small Business Investment Incentive Act of 1980, Congress believed that eligible portfolio companies included a large majority of all public companies and that it authorized the Commission to expand the category even more; (2) describes the market capitalization levels in 1980 dollar equivalents and suggests ways to put those levels in perspective; and (3) summarizes the evidence in the public comment file that describes the attributes of companies (based on market capitalization levels) that create significant challenges to raise capital in the public markets (see Attachment).

Given the current problems in the capital markets, and especially the credit markets, it would be hard to find a more appropriate time for the Commission to remove outdated and unnecessary barriers that prevent Business Development Companies (BDCs) from providing capital to middle market and growing companies.

The Commission has already concluded that the current definition of “eligible portfolio company” (EPC) that relies on the Federal Reserve Board definition of marginable securities is no longer appropriate given the dramatic change in the eligibility criteria made by the Federal Reserve Board for unrelated reasons.<sup>1</sup> The legislative history clearly shows that in 1980 Congress understood the very broad scope of the companies it intended to qualify to as “eligible portfolio companies” for BDC financing. The Committee Report accompanying the bill states that:

the pool of such eligible portfolio companies under the Bill is very broad...It is estimated there are about 12,000 publicly held operating companies; the definition of ‘eligible portfolio company’ would include about two-thirds, or 8,000 of those companies, plus all privately-held companies. In addition, the Commission is given rulemaking authority to expand the class of eligible portfolio companies....<sup>2</sup>

In an effort to put into context market capitalization levels of public companies that would have qualified as EPCs in 1980, we sought data to distinguish the market capitalization levels of securities that were listed on the Federal Reserve Board’s 1980 published list of marginable securities from those that were not. However, the company-by-company data is simply not available.<sup>3</sup> Even if that precise data existed, we are not certain that it would lend much probative weight to the determination of an appropriate market capitalization standard for EPC given the enormous changes in the capital markets that have taken place since 1980 -- including market liquidity evidenced by daily trading volumes and the evolution of modern trading platforms --as we describe in more depth below.

The margin rules themselves were not intended to be a simple demarcation of larger versus smaller companies. The Federal Reserve Board designated “OTC margin stock” as stock that it determined had “the degree of national investor interest, the depth and breadth of market, the availability of information respecting the stock and its issuer, and the character and permanence of the issuer...”<sup>4</sup> to warrant allowing the stock to be purchased on margin. Size itself was not the significant factor that qualified a security for margin eligibility. Instead, the Federal Reserve Board’s regulation indicates that it determined eligibility based on the overall market following of the stock. We believe that looking at the market following, the depth and breadth of the market, and the availability of information about a stock and its issuer remains relevant today, even if the actual list of OTC margin stock does not.

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<sup>1</sup> *Definition of Eligible Portfolio Company Under the Investment Company Act of 1940*, Proposed Rule, File No. S7-37-04 (November 8, 2004) [69 Federal Register 648187-8].

<sup>2</sup> House of Representatives Report No. 96-1341, Small Business Investment Incentive Act of 1980 (to accompany H.R. 7554), September 17, 1980, page 23.

<sup>3</sup> We sought assistance from the research arms of Merrill Lynch, the New York Stock Exchange, and NASDAQ. They advised us that there is no database that exists that describes market capitalization based on the list of such companies.

<sup>4</sup> 1978 NASD Manual, Regulation T and SEC Rules Regulation 220.2.

The public comment file is fulsome in its description of the market following of public companies of various market capitalization levels as measured by trading volume, analyst coverage, institutional ownership, recent offering activity, and other factors that demonstrate a company's market following. Companies with market capitalization levels of less than \$250 million have no significant market following, and are the companies that have varying degrees of difficulty accessing follow-on equity and credit from the public markets. The Commission has used these same factors in other rulemakings to determine the extent of market following and appropriate market capitalization levels.

Nevertheless, it is instructive to look at what market capitalizations in 2008 dollars would have meant in 1980 equivalents, and to put the market capitalization levels into perspective. The chart below, using the National Aeronautics and Space Administration's Gross Domestic Product Deflator Inflation Calculator<sup>5</sup>, describes the 1980 and 1983 equivalents.

#### **MARKET CAPITALIZATION ADJUSTED FOR INFLATION**

<b>2008</b>	<b>1983</b>	<b>1980</b>
\$300	\$170.88	\$139.50
\$250	\$142.40	\$116.25
\$200	\$113.92	\$93.00
\$150	\$85.44	\$69.75
\$100	\$56.96	\$46.50

In 1980, when Congress first adopted the definition of EPC, the vast majority of public companies were not considered appropriate for margin eligibility, largely because NASDAQ had not yet evolved into a trading platform with issuers perceived as equivalent to the exchanges. In fact, in 1980 there were considerable differences in issuers between those listed on the exchanges and those relying on the over-the-counter market. The vast majority of public companies traded on NASDAQ did not have a sufficient market following, and certainly insufficient trading volume, to make them eligible for margin treatment.

It was not until 1983, when the NASDAQ National Market System (NMS) was fully operational, that NASDAQ evidenced what was largely perceived as a market with issuers of greater depth and breadth. But the NMS stocks were still not large in number. NMS started in April 1982 with 40 companies. By the end of 1983 there were 682 securities included in the NMS. The rapid growth in NMS stocks eventually led to all NMS securities being automatically eligible for margin treatment. This automatic treatment became effective in November 13, 1984. These are developments that Congress could not have predicted in 1980 when the original definition of EPC was adopted.

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<sup>5</sup> <http://cost.jsc.nasa.gov/inflateGDP.html>

According to the NASD 1983 Fact book:

By the end of 1983, a profile of companies and their securities traded on NMS had emerged. The average share price was \$20.15 and there was an average of 7.7 million shares outstanding...and [average] market value was \$154.4 million.<sup>6</sup>

Using the NASA DDP calculator, the size of the average NMS traded company in 1983 would be equal to \$271 million in 2008 dollars. This figure puts into some perspective what market capitalization levels meant in the early 1980s.

Another indicator of how to put 1980 market capitalization into perspective is the 1980 New York Stock Exchange listing standards for foreign companies. Because “of the widespread use of ‘bearer’ shares in other countries, in contrast to the U.S. practice of registered shares, a company would find difficulty in certifying the requirements of 5,000 round-lot shareholders on a worldwide basis. Therefore the Exchange will require that a member firm attest to the liquidity and depth of the market for the company’s shares.”<sup>7</sup> However, the minimum market capitalization for a foreign company was set much higher than a domestic issuer. In 1980, under the Exchange’s “Alternative List Standards – Foreign Companies” a foreign company trading on the NYSE would have needed a market capitalization of at least \$100 million (equal to \$215 million in 2008 dollars).<sup>8</sup> In addition, the stock would have to satisfy several other factors.

Credit and capital are probably harder to come by today than anytime in the past 20 years. The public comment file is replete with empirical evidence that public companies, many well in excess of \$250 million in market capitalization, have had to turn to non-traditional providers of capital in recent years. For example, data on private investment in public equities (PIPEs) demonstrates the demand for capital by public companies in ways that do not involve traditional debt or equity offerings. It would be ironic that given recent efforts by the Commission to take enforcement action against certain PIPE transactions that involve alleged market manipulation and harm to public companies relying on PIPE transactions for capital, that it would limit the ability of these public companies to seek financing from BDCs – companies that are subject to the transparency, reporting, and other obligations of the Investment Company Act of 1940. Another example in the public record is the in-depth discussion and empirical data on the types of companies by size to which financial institutions extend credit.

In conclusion, after more than three years of consideration and hundreds of pages of public comment, the Commission has yet to modernize the definition of “eligible portfolio company” under the Investment Company Act of 1940. Although Congress clearly stated in 1980 that it intended that the definition of EPCs include the vast number of public companies, it also understood that over time that its broad definition may

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<sup>6</sup> NASD 1983 Fact Book, p. 6.

<sup>7</sup> 1980 New York Stock Exchange Fact Book, p. 29.

<sup>8</sup> The standard pre-dated 1981 and is described as a May 1976 standard. Adjusting the standard for inflation from 1976 would equate to \$290 million in 2008 dollars.

become inadequate to accomplish its policy objective in creating BDCs because of unpredictable changes in the capital markets. It therefore granted broad authority to the Commission to expand the definition and include an even greater number of public companies.

In 1980, Congress could not have foreseen that the financial markets would change so dramatically and rapidly, nor that the Federal Reserve Board would deregulate its margin requirements such that most public companies would no longer be considered EPCs. It was for just such a reason that Congress granted the Commission broad authority to expand the definition consistent with the original policy objective – companies without sufficient market presence to command easy access to the public capital markets should be eligible investments for BDCs.

We urge the Commission to adopt a definition of eligible portfolio company that includes public companies with a market capitalization of \$250 million or less.

Sincerely,

A handwritten signature in black ink, appearing to read "David A. Starr", written in a cursive style.

David A. Starr

cc: Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Annette L. Nazareth  
Commissioner Kathleen L. Casey

## **EXAMPLES FROM THE PUBLIC COMMENT FILE**

### **COMPANIES OF LESS THAN \$250 MILLION IN MARKET CAPITALIZATION HAVE INSUFFICIENT ACCESS TO CAPITAL**

The following are some examples of factors already in the public record demonstrating that companies with less than \$250 million in market capitalization tend to lack sufficient access to capital from the public markets.

- There is a demand for additional capital by smaller public companies. In 2005, over \$5.85 billion in private investments in public companies (PIPE) financings were entered into by public companies with market capitalizations of up to \$250 million, demonstrating significant demand for capital from non-traditional funding sources.
- Market indexes for small capitalization stocks, which include generally illiquid securities and have little market following, have a market capitalization range from a median of \$600 million to over \$1 billion.
- Follow-on equity issuances as well as debt issuances for companies with market capitalizations of \$250 million or less were very limited, illustrating the restricted access of these companies to the public equity and debt markets – generally considered the lowest cost option for a public companies.
- Companies with a market capitalization of less than \$250 million have limited or no analyst coverage.
- There is little institutional ownership in public companies with market capitalizations of less than \$250 million.
- Public companies with market capitalization levels of less than \$250 million have thin trading volumes.
- Market participants that provide public capital have largely moved away from serving the needs of companies with market capitalizations of less than \$250 million, and instead are focused on issuers with greater revenues than those represented by companies with less than \$250 million in market capitalization.