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SMALL BUSINESS CAPITAL FORMATION: A Growing Concern at the SEC

Remarks of
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It has often been said that the three most disbelieved statements are: 1) The check is in the mail; 2) I can get you a loan at two points below prime; and 3) I'm from the government and I'm here to help you. Well, I'm from the Securities and Exchange Commission and I am here to help you. That is, I'm here to tell you that the SEC wants to help to facilitate small business capital formation. To some that would seem to be a revolutionary notion. After all, isn't the SEC preoccupied with investor protection and the maintenance of fair and orderly securities markets, and isn't the SEC the agency which deals with big Wall Street, big swindlers and big corporations? And what does any of that have to do with small business capital raising?

The fact is that historically, to the small business, the spectre of submitting to, and complying with, SEC rules and procedures with the attendant expense of high priced lawyers and accountants who generated extensive paperwork was frightening enough to chill the ambition of many entrepreneurs. Although the reality was never as bad as the perception, the fact is that for decades, the particular needs of small business were not given consistent attention at the SEC.

Lest I be accused of overstating the case, I should point out that as far back as the 1930's, when the Commission was in its formative years, there is evidence of concern for small

business. One of our first Commissioners, the eminent William O. Douglas, expressed great interest in finding effective ways of enhancing capital raising opportunities for small business. A study undertaken by the SEC in 1937 found that the relative cost of raising capital for small business was significantly higher than for large companies. Indeed, in response to a request from President Roosevelt that the SEC consider simplification of regulations to assist and expedite the financing of small business, the Commission expanded exemptions from registration for issues under \$100,000 and created a simplified registration procedure for issues of less than \$5 million. Such expressions of concern are notable, but have been sporadic during the almost 50 years of the Commission's existence.

I have come here, however, to report that in recent years, the SEC has become far more sensitive to the needs of small business. In this connection, we have taken many concrete steps, a number of which I will describe today, to make the capital markets more accessible to small business and we have done so without harmful dilution in investor protection.

Why have we taken these steps? We have done so because small business represents the most vital and productive sector of our economy. Small firms comprise 97% of all U.S. companies and account for 43% of the Gross National Product. As many as 66% of all new jobs in the U.S. are created by companies with 20 or fewer employees and up to 77% of all new jobs are created

by firms with 50 or fewer employees. Moreover, small business has been proven to be a more prolific source of innovations per dollar than medium or large businesses. From the standpoint of social policy, it is well known that small firms provide the most significant economic opportunities for minorities and women, both as employees and entrepreneurs. Indeed, the President recently observed in his report to Congress on the state of small business that such enterprises are the heart of the U.S. economy and the free enterprise system.

Although the importance of small business in our economy has not diminished over the years, the difficulties which confront small business have increased. Small businesses have traditionally faced a more difficult challenge than larger companies in satisfying their capital needs. However, in recent years, high and volatile interest rates, persistent inflation and severe recession have exacerbated the situation. It is ironic that even as the stock market has shown new vitality and vigor in recent months, we have seen the highest rate of bankruptcy in fifty years. Not surprisingly, the majority of these economic casualties have been small businesses.

Yet, it is clear that sustained economic prosperity is inexorably tied to the fortunes of small business. Accordingly, the Federal government has in recent years begun to give the problems of small business significant attention.

For its part, over the past four years, the SEC has made important strides toward reducing regulatory burdens that inhibit small business capital formation. I would like to review briefly these developments.

The evolution of the Commission's present concern with small business capital formation can be traced to April and May, 1978, when a series of public hearings were held to discuss the particular financing problems of small firms. Subsequently, in 1979, the Commission, at the recommendation of its Advisory Committee on Corporate Disclosure, undertook an evaluation of the impact of its rules and regulations on the ability of small business to raise capital. Both the hearings and the study disclosed that the registration provisions of the Securities Act imposed disproportionate burdens on small issuers.

Also during 1979, the Commission adopted Form S-18, which provides certain small issuers with an alternative and effective means of raising limited amounts of capital through a registered public offering. Specifically, the narrative and financial disclosure requirements are substantially less burdensome than those which would otherwise be required if the general form, Form S-1, were used. Additionally, the Commission, for the first time, provided issuers registering securities on Form S-18 with the option of filing the registration statement at the appropriate regional office

or at the headquarters office. Recently, Form S-18 was made available to limited partnerships and to registrants in oil and gas related operations.

Even Regulation A, the traditional small issuer financing mechanism, has been revised to make it more responsive to the needs of small business. In this connection, Regulation A, which can be used for public offerings of up to \$1.5 million, was amended in 1979 to allow the use of a preliminary offering circular, which permits issuers to receive indications of interest from potential purchasers prior to the time the offering has been reviewed and authorized by the Commission. This procedure is analagous to the use of "red herring" preliminary prospectuses employed with respect to full registrations. In addition, in 1981, the Commission revised and updated the disclosure requirements of Regulation A in order to save time and money for issuers by codifying administrative practices that had developed through staff review of such filings over the previous 20 years.

In April 1982, the Commission adopted a classification system for the purpose of exempting small issuers from the registration and reporting requirements imposed by the Exchange Act. Before the system was implemented, many small companies with relatively few shareholders and whose stock was not widely traded were subject to the same costly reporting requirements as large publicly held companies. The new classification system enables many small companies to raise the capital necessary for operations without incurring the expense of the registration and reporting requirements of the Exchange Act.

Pursuant to these new rules, only companies with 500 or more shareholders and \$3 million or more in total assets must register under Section 12(g) of the Securities Exchange Act. In addition, companies which are already reporting pursuant to that Section may discontinue reporting when they are left with fewer than 500 shareholders and total assets less than \$3 million at the end of each year of its last three fiscal years. Under this new system, it is anticipated that approximately 500 small companies which were previously required to comply with the Exchange Act reporting requirements will now be exempt from registration. For those companies, this deregulation will substantially reduce the costs of doing business and raising capital.

Another significant development giving particular impetus and new focus to the Commission's efforts on behalf of small business was the passage by Congress of the Small Business Investment Incentive Act of 1980. This legislation grew out of many months of searching by the Congress, the Commission, and the private sector for methods of encouraging the mobilization of capital for new, small and growing enterprises, without sacrificing investor protection or investor confidence in the capital markets. The key provisions of the legislation consisted of amendments to the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

The amendments to the Securities Act made two significant changes to aid in the capital formation process. First, the Commission is now permitted to exempt from its regulation small offerings of up to \$5,000,000 rather than the previously authorized \$2,000,000 aggregate offering price limitation. Second, a new Section 4(6) was added to exempt from the registration requirements transactions involving offers and sales to so-called "accredited investors" where the aggregate offering price does not exceed the \$5,000,000 limit and no advertising or public solicitation is involved in the offering. "Accredited investor" is defined in Section 2(15) to include certain institutional investors including, among others, banks, investment companies, and employee benefit plans.

The Investment Company Act was amended to exempt "business development companies" from certain of its regulatory provisions. Business development companies are types of investment companies that choose to participate in the development of small and financially troubled companies by providing both capital and managerial expertise. The recent amendments make it easier for these companies to raise capital, to enter into closer management relationships with their portfolio companies, and to recruit the necessary executive talent, without violating the Investment Company Act.

Finally, in the Small Business Investment Incentive Act, Congress charged the Commission with a specific mandate to assist small business capital formation. Two provisions clearly express this intent.

First, the legislation directs the Commission to cooperate with state securities regulatory agencies to promote uniformity in securities regulations and to reduce paperwork. This new provision, Section 19(c) of the Securities Act, encourages collaborative work by federal and local authorities on such projects as standardization and elimination of forms, duplication in clearance procedures, and development of a uniform small business exemption. Significantly, it is a declared policy of the provision that enhanced state and Federal cooperation should be directed towards, among other things, "minimum interference with the business of capital formation."

Second, the legislation directs the Commission to conduct an annual Government-Business Forum on Small Business Capital Formation. The first such forum, which I will discuss more fully in a moment, was held by the Commission in September.

Taken as a whole, the Small Business Investment Incentive Act has further invigorated the Commission's efforts on behalf of small business capital formation and has already spurred significant rule changes and other activity on behalf of small business.

I would now like to address the Commission's most recent responses to the capital needs of small companies: Regulation D, and the first of our Government-Business Forums.

Regulation D represents the most ambitious initiative undertaken by the Commission to exempt certain limited offerings from the time and expense of full registration. Securities sold

in exempt limited offering transactions have historically played a significant role in the capital formation process. It is estimated that 7.5 billion dollars was raised under the Section (4)2 exemption alone in 1981. 1/ In view of the importance of exempt offerings, especially to smaller companies, the Commission, through the Office of Small Business Policy, undertook an overall evaluation of the limited offering exemptive scheme to determine what modifications could be made to eliminate compliance burdens and reduce costs consistent with the protection of investors. Regulation D, 2/ adopted by the Commission on March 15, 1982, represents the end product of this process.

Prior to the adoption of Regulation D, the Commission's limited offering exemptions were contained in three separate rules which had been adopted over a span of ten years. These rules were criticized for several reasons, including inconsistent definitions and requirements, inadequate offering amounts, and

1/

Based on a survey conducted by the Directorate of Economic Policy Analysis of 50 issuers estimated to have privately issued securities constituting 70-75% of the private placement market. This figure does not include exempt offerings which used Rule 146.

2/

Regulation D is a series of six rules, designated Rules 501-506. Rule 501 contains common definitions and terms as they are used throughout the regulation. Rule 502 sets forth general conditions to be met which apply to the exemptions contained in the regulation. Rule 503 provides for a uniform notice of sales form, designated Form D, to be used for all exempt offerings pursuant to Regulation D and Section 4(6) of the Securities Act. Finally, Rules 504-506 contain the specific exemptions from the registration provisions of the Securities Act.

uncertainty as to their availability because of subjective determinations that had to be made by the issuers.

Regulation D represents the SEC's attempt to reduce costs by responding to these and other concerns through the coordination of the various exemptions, streamlining of the existing requirements and expansion of the amounts which can be raised. Of special importance, the Regulation expanded the "accredited investor" concept to specifically bring within the private offering exemption under Section 4(2) certain classes of purchasers deemed to be able to fend for themselves and not to need the protections provided by the registration process. These persons include, among others, 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 persons who purchased at least \$150,000 worth of securities being offered without regard to their earnings, so long as the total price does not exceed 20% of their net worth.

Any company that sells securities in an offering exempt from the Securities Act must still comply with the requirements of each state in which the offering will be made. With 50 state jurisdictions regulating these sales, inevitably, the standards have varied significantly from state to state. Both large and small companies historically have incurred substantial "blue sky" expenses in complying with these requirements.

The Commission's Office of Small Business Policy has worked closely with the North American Securities Administrators'

Association to develop Regulation D as a model for a uniform federal-state exemption. In April 1982, the NASAA membership endorsed a uniform state limited offering exemption which incorporates Regulation D, and already, 17 individual states have adopted Regulation D type exemptions. Greater uniformity will substantially reduce "blue sky" expenses and extend the substantial benefits of Regulation D to offerings at the state level.

As I mentioned earlier, the first Forum on Small Business Capital Formation was held in September, 1982. The Forum presented a unique opportunity for small businesses, government regulatory agencies, and private sector organizations interested in small business to gather to discuss the existing impediments to small business capital formation, with the expressed objective of developing concrete corrective recommendations to be sent to Congress and the appropriate regulatory agencies.

The Forum participants, a large number of whom were small business persons, developed 39 specific legislative and regulatory recommendations as actions that could be acted upon to improve the climate for capital formation and retention. Let me note a few of these recommendations.

First, it was recommended that Congress amend the Internal Revenue Code to provide an investment tax credit, equal to 10% of funds invested in a "Qualified Small Business Investment." A Qualified Small Business Investment would consist of a debt or equity security issued by a Small Business Investment Company,

Business Development Company, or small business as defined by the SBA, and which, among other things, cannot permit the investor to require repayment sooner than five years after the date the investment is made.

A second recommendation was that state securities administrators develop, and seek enactment of uniform exemptions that parallel Regulation D.

In addition, it was also recommended that Congress adopt legislation permitting a substantial investor in a small business, who has attained the age of 65 and has held his investment for ten consecutive years, to sell his shares and have a certain portion of any capital gain be exempt from taxation. This innovative proposal is analagous to the one-time capital gain exemption available when a person sells his principal residence.

The Commission's staff is currently preparing a final report to Congress on the Forum for publication this month. Both the House Subcommittee on Tax, Access to Capital and Business Opportunities, and the Senate Small Business Committee have expressed an interest in holding hearings in the near future on the small business capital formation issues addressed, and the recommendations developed at the Forum.

Conclusion

In closing, I would like to emphasize that the SEC is vitally interested in the capital formation problems which small businesses face. While the central focus of the Commission is and should remain on investor protection, the net result of

Notwithstanding that the central focus of the Commission is, and will remain, on investor protection, we believe that by protecting investors, and maintaining their confidence in the fairness of our securities markets, the SEC will in turn facilitate the ability of small companies to attract the capital of those seeking the opportunity to reap the benefits of corporate growth. Thus you should be assured today that we at the Commission -- while remaining sensitive to the needs of investors, the true backbone of a strong and vibrant capital market -- will keep searching for new ways to reduce regulatory burdens on small business.