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**NEWS**

**SECURITIES AND  
EXCHANGE COMMISSION**  
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THE SEC GOAL--

INVESTOR PROTECTION WITH MINIMUM REGULATION

Address by

John R. Evans  
Commissioner  
Securities and Exchange Commission  
Washington, D.C.

15th Annual Meeting  
National Association of  
Small Business Investment  
Companies  
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Allen Caldwell

When it was rumored last February that the President would nominate me to be a Securities and Exchange Commissioner, one of the first calls I received was from your counsel, Charles Noone, whom I had known because of his support of legislative proposals beneficial to small business investment companies which the Senate Committee on Banking, Housing and Urban Affairs considered while I was a staff member of the Committee. Mr. Noone explained that your Association would like me to participate in your annual meeting. I responded that such an invitation was premature because, unless he knew something I didn't know, there was no assurance that I would be nominated by the President or confirmed by the Senate. I told him, however, that if these events did occur and if you still wanted me to come, I would be happy to participate in your meeting.

I have now served eight months on the Commission, and today I am pleased to be with you in Arizona where I was born and about which I have many fond memories of my youth. Being the son of a small business man and having had the opportunity to work for many years with my father, I feel

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that I understand many of the problems confronting small businesses, including the difficulty they sometimes have in obtaining adequate funds to finance their operations.

I suppose with that experience it is natural that I would have a dislike for government regulations, which frequently require burdensome paperwork and impose restrictions that often seem to be intended to make life more difficult for business enterprises instead of fulfilling a necessary purpose. Because men and women work best in an atmosphere of freedom, I favor as little government regulation as possible. I believe that the major responsibility of government is to foster an environment in which individuals, through private enterprise, will have incentives to provide desired goods and services. Assuring that capital is available to finance such enterprises through private institutions and that individuals can invest their savings with confidence is a fundamental part of that responsibility.

Both the small business investment company industry, which was made possible by the Small Business Investment Act of 1958, and the Securities and Exchange Commission have an interest in seeing that adequate funds are available to business enterprises. Your interest is properly based on the

profit motive, and the Commission's responsibility arises from a Congressional mandate.

When Congress created the SEC in 1934, it gave the Commission the responsibility to make sure investors are protected against improper practices in ~~the~~ <sup>our</sup> securities and financial markets. Almost parenthetically, this mandate is also a charge to maintain strong capital markets which, I believe, can exist only when public investors are provided with adequate disclosure and protections against fraudulent conduct.

During the past few years as our society has become more complex and impersonal, many of the restraints on improper activities by individuals have weakened or disappeared. In earlier times, the family, the church, and the community provided strong support for ethical conduct. In a community where one's activities were, in most instances, immediately known by his neighbors who were also his relatives, friends and close associates, unscrupulous conduct was usually quite easily controlled. With the decline in the influence of the family, church and community, a greater responsibility has been placed on the Securities and Exchange Commission to foster and maintain high standards of ethical conduct in our capital markets.

Traditionally, the Commission has performed well in meeting its responsibility, and has helped establish and maintain the best capital market in the world. This has been accomplished through prudent regulation and effective enforcement which ~~is~~<sup>are</sup> more strict than would have been necessary if individuals could be trusted to be honest in their dealings. As the noted British statesman Edmund Burke observed,

"Men are qualified for civil liberty in exact proportion to their disposition to put moral chains upon their own appetites. Society cannot exist unless a controlling power upon will and appetite be placed somewhere, and the less of it there is within, the more there is without. It is ordained in the eternal constitution of things that men of intemperate minds cannot be free. Their passions forge their fetters."

Unfortunately, there is no way to regulate only those who are dishonest. Regulation must be across-the-board and admittedly a relatively few problem cases can make life somewhat more difficult for many others. It is a fact, however, that the rules and regulations which are frequently the subject of criticism are the very basis of an environment in which honest individuals can foster their enterprises. This being the case, good regulation and enforcement are not

anti-business or anti-small business investment company. They simply foster an environment in which business may prosper while protecting investor interests.

The enactment of the Small Business Investment Act of 1958 marked the beginning of a relationship between the SBIC industry and the SEC which can only be characterized as one of mutual apprehension. As you well know, the Commission has always viewed publicly-held SBICs as investment companies which should be regulated under the federal securities laws, even though such SBICs are, in most instances, different from other registered investment companies. On the other hand, the SBIC industry has viewed the federal securities laws as serious impediments to their efforts in providing venture capital for small business.

Overlapping jurisdiction and regulation of small business investment companies by the Commission and the Small Business Administration <sup>have</sup> ~~was~~ been of concern to the industry since the inception of the program. In 1959, one year after enactment of the Small Business Investment Act, hearings were held on the SBIC program and representatives of your Association urged the Senate Select Committee on Small Business to take the lead in exempting SBICs from the

Investment Company Act of 1940. In the same year, the Senate Committee on Banking and Currency after considering the industry proposals stated in a report that: *quote*

"...the committee believes it is premature to recommend amendments to the Investment Company Act of 1940, pending development of the program and the operation of small business investment companies over a greater period of time. In the meantime, however, it urges the SEC and the Small Business Administration to cooperate in minimizing duplication of regulation and reporting requirements."

Congressional hearings were held again during the early 1960's on the desirability of exempting SBICs from the Investment Company Act and in 1963 a Senate report stated:

"First of all, the protection of SBIC investors must be assured. To permit any form of abuse to creep into this relatively new program would surely prove fatal. For this reason, your committee is doubtful that a blanket exemption of SBIC's from the 1940 Act is advisable. Secondly, the program must be kept free of unnecessary and overlapping regulation."

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"The matter resolves itself, then, into a balancing of these two factors: assuring investor protection on the one hand, while leaving the degree of freedom necessary to facilitate the provision of capital and credit to small firms on the other."

Although the Commission granted certain exemptions from the 1940 Act during the next few years, the SBIC industry considered them to be insufficient and ineffective. Having been turned down by Congress in attempts to obtain exemptions and believing that the SEC had not provided appropriate relief through its authority under the 1940 Act, the industry filed a comprehensive application with the Commission on March 15, 1968 requesting exemptions from almost all substantive sections of the Act. This application was the subject of an extensive hearing and oral argument before the Commission. Although an opinion issued by the Commission on May 14, 1971 denied most of the industry request and granted only an exemption with respect to the issuance of qualified stock options, it did mark a salutary turning point in SEC and small business investment company industry relations. Our staff began to consider more seriously the possibilities of using the authority provided in the Investment Company Act as well as the other federal securities laws not only as a means to achieve maximum investor protection, which is the Commission's major responsibility, but also as a means to reduce regulation relating to SBIC activities. The process of achieving this goal, as you all well know, takes time, perhaps too much time. But I can assure you that the



Commission is working towards reducing regulation to the extent possible consistent with necessary investor protections.

Let's consider some of the achievements that have been made in the past two years. Perhaps the first breakthrough was the program for SBA Guaranteed Offerings of SBIC Debentures. Prior to the amendment of the Small Business Investment Company Act permitting this program, Mr. Kleppe, Administrator of the SBA, requested and received a no-action letter from the <sup>SEC</sup> staff relating to Sections 18(c) and 3(c)(1) of the Investment Company Act. The effect of this staff position, predicated on the fact that the securities guaranteed by the SBA contained the characteristics of a government security, was very significant. Non-registered investment companies could sell SBA guaranteed debentures to the public in \$10,000 denominations without being required to register under the Investment Company Act, and registered companies were able to issue such debentures without being subject to the Act's restrictions on senior securities. Thirty million dollars was raised in the first offering of SBA guaranteed debentures.

Subsequent to that offering and at the SBA's request, the Commission promulgated two new rules exempting, upon certain conditions, SBA guaranteed debentures from the term

"public offering" as used in Section 3(c)(1) of the 1940 Act and from the restrictions of Section 18(c) of the Act relating to senior securities. Following the adoption of these two rules in April 1972, there have been <sup>low</sup> ~~high~~ SBA guaranteed debenture offerings totaling <sup>over</sup> \$153,000,000. <sup>this</sup> ~~in~~ addition, I understand that there is <sup>an offering for \$50,000,000 which was just completed last month. 29th of Oct.</sup> ~~an offering now being made for \$50,000,000.~~ We at the Commission are pleased that we have been able to help facilitate these offerings without sacrificing investor protections.

*Oct 29th*

Also of particular interest to SBICs is the Commission's recent Rule 144. I am sure you are familiar with the problems of uncertainty as to when, or if, securities received in a private offering could be offered on the market without registering those securities under the Securities Act. The degree of certainty provided by the rule is especially important for SBICs because practically all of your portfolio securities are obtained in private offerings. You may think this rule is too narrow. You may think it should have gone much further, but there is no doubt that it is a major improvement. Again, this was provided without any significant decrease in investor protection.

A major step in considering SEC regulation of SBICs was taken when former Chairman Casey established an Advisory Committee on Investment Companies and Advisers in September of last year. Among the members of that committee, which published its report and made its recommendations on December 29, 1972, was your Counsel, Charles Noone. The most important recommendations pertaining to SBICs were:

(1) that a small specialized staff unit be established in the SEC to deal with SBIC problems;

(2) that consideration be given to additional exemptive rules under Section 17--the anti-self dealing section--to relieve SBICs from burdensome application procedures;

(3) that a review be made of the annual report (N5-R) required by the Commission to simplify and eliminate duplication with the annual report (Form 468) <sup>which</sup> for SBICs <sup>are required to</sup> file with the SBA; and

(4) that registered SBICs be permitted to use Article 6 instead of Article 5 of the Commission's accounting rules (Regulation S-X)..

Shortly after this report was published, a staff task force was created to study the Advisory Committee report

and, where appropriate, develop proposals for implementation. The staff is well along with its review and will soon send its recommendations <sup>to</sup> the Commission for our consideration.

The Commission has already taken some action and I expect it to act further to implement the recommendations <sup>made</sup> by the Advisory Committee. Even prior to the ~~Commission's~~ <sup>Committee's</sup> recommendations, the Division of Corporation Finance, in an effort to improve staff efficiency, designated one branch in that Division to process all filings of SBICs for which that Division is responsible under the Securities Act and the Investment Company Act.

In response to the Advisory Committee recommendation, a special staff unit has been established to deal with SBIC problems. This unit consists of Sydney H. Mendelsohn, Assistant Director of our Division of Investment Management Regulation, <sup>who participated on the next panel</sup> and Anthony A. Vertuno, Special Counsel in our Division of Corporation Finance, <sup>who will participate along with Sid on the next panel.</sup> While these senior staff members operate as a unit, Mr. Mendelsohn works principally with the regulatory problems of SBICs under the Investment Company Act and Mr. Vertuno is primarily responsible for SBIC filings processed in the Division of Corporation Finance and the interpretation of the Securities Act. Since its

creation over six months ago, attorneys and officers of SBICs and representatives of your association have been discussing with this staff unit questions concerning the application of the federal securities laws to small business investment companies. In addition, the members of this staff unit have held meetings with SBA representatives for the purpose of acting on mutual problems relating to the SBIC industry. Problems which previously would have taken much longer to be resolved are being handled more expeditiously because of this special staff unit.

With respect to the recommendation that the Commission consider additional exemptive rules under Section 17 of the Investment Company Act, our Division of Investment Management Regulation is considering several industry proposals and has almost completed the drafting of a proposed rule to exempt certain joint transactions from the application requirements of the 1940 Act in circumstances in which it appears that SBIC participation would not be inconsistent with the objectives of the Act. This rule will be designed to exempt, under appropriate circumstances, joint transactions such as: (1) transactions involving capital reorganizations of SBIC affiliated portfolio companies; (2) transactions involving mergers of SBIC

affiliated portfolio companies with the SBICs or with controlled companies of the SBICs; and (3) common investments by two or more SBICs where their only affiliation is derived from another common investment in a small business concern. I expect the Commission to publish this proposed rule for public comment in the very near future. If adopted, this rule should substantially reduce a heavy paperwork burden and save precious time for SBICs and our staff without sacrificing investor protection. A great deal of credit for the development of this proposed rule must go to the cooperative efforts of representatives of your industry with our staff.

The Commission is prepared to consider other suggestions for relief, and I urge you to contact <sup>our special</sup> ~~the~~ staff ~~division~~ unit with your suggestions. Obviously, all suggestions are not going to be adopted, but they will be thoroughly considered and relief will be granted when it is clear that investor protection will not be impaired.

The Advisory Committee's recommendations concerning Regulation S-X and the elimination of duplication in the annual reports filed with the Commission and the SBA by registered SBICs require a joint effort by the Commission and the Small Business Administration. Certainly it is possible to

eliminate SEC and SBA duplicative reporting requirements by developing a single form which would serve as an annual report for both agencies, and the Commission supports such an effort.

I understand that the SBA is currently developing a proposal for submission to the Commission which would permit SBICs to carry their portfolio securities either at value with cost shown parenthetically or at cost with value shown parenthetically as is permitted for closed-end management investment companies under Article 6 of Regulation S-X instead of requiring them to comply with the provisions of Article 5 as is presently the case. Although it may be difficult to determine accurately the market value of holdings in small business concerns because such securities are often not marketable, I favor such a proposal and can assure you that it would be sympathetically considered by the Commission.

*this would be in line with the AGLPA audit & accounting guide, which has been discussed by Robert Maynard*

The Advisory Committee report also referred to Regulation E under the Securities Act of 1933 but no formal recommendations were made. For those of you who may not be familiar with this Regulation, it permits SBICs to make public offerings of their securities within a maximum offering price of \$500,000 without complying with the full registration requirements under the Securities Act. Although a number of

SBICs have initiated filings under Regulation E, as far as I am aware, only one issuer has actually completed such an offering.

It would certainly appear that the use of Regulation E has advantages for an SBIC. The fee for a Regulation E filing is a flat \$100 as compared to a minimum fee of \$100 for a full Securities Act registration. Also, legal and accounting fees should be lower than for a Securities Act registration statement. Thus, as the Advisory Committee indicated in its report, Regulation E "would appear to facilitate the growth of SBICs."

Let me point out, however, that Regulation E is not a substitute for the registration statement required by Section 8(b) of the Investment Company Act. Keeping this point in mind, it is clear that Regulation E would be most useful for SBICs which have previously completed their Investment Company Act registration statements and are trying to raise additional capital. Of course, if SBICs are finding particular problems under Regulation E, written comments and suggestions should be directed to the Commission's ~~staff members~~ *staff members assigned to the special SBIC unit.*

As you can see, the Commission is actively considering, and will no doubt approve, regulatory changes



*reducing reporting, exempt some SBIC activities from Investment Company Act requirements and*  
which will greatly assist small business investment companies  
to provide equity capital and long term loans to small  
business firms. While it might be said that the Commission  
has been overly cautious in granting exemptions; ~~from~~ the  
Commission *believes that* ~~point of view~~ such caution is better than not  
being cautious enough.

Even with the restrictions of the 1940 Act, the  
Commission has uncovered and prosecuted a number of serious  
violations involving SBICs. I am sure many of you are  
familiar with the Commission's past enforcement actions in  
response to self-dealing in Advance Growth Capital Corporation,  
Illinois Capital Investment Corporation, and Puerto Rico  
Capital Corporation, *which were some of the most serious violators!*

No doubt frustrated by the Commission's cautious  
approach in granting exemptions, the industry has again  
sought Congressional action. Less than two weeks ago S. 2628,  
a bill which would provide a blanket exemption for SBICs from  
the Investment Company Act of 1940, was introduced in the  
Senate. The SEC has opposed such blanket exemptions from  
securities statutes in the past and for reasons which I would  
like to discuss, can be expected to oppose S. 2628.

Exemptions from securities laws which have been  
provided for institutions under the jurisdiction of other

regulatory authorities have made it very difficult, if not impossible, to assure equal regulation, equal enforcement, equal investor protection, and thus competitive equality. As a result, the Commission has been requested by several members of Congress to draft legislation which would remove some of the present exemptions.

The Commission believes that securities activities can best be regulated by one agency which can objectively consider the differences in various institutions rather than authorizing each primary regulatory agency to adopt securities regulations for institutions under its jurisdiction. An *agency that does not have investor protection as its primary purpose* may naturally be expected to view securities regulation as secondary to the specific purpose for which it was created.

The primary purpose of SBA with respect to SBICs may appropriately be to provide maximum debt and equity capital to small business firms not able to obtain such resources from banks or directly from the market. Bank regulators may be primarily concerned with monetary policy or the safety of depositor's funds or the health of our commercial banking system. The primary concern of the Federal Home Loan Bank Board may be to provide funds for

construction of housing and the health and safety of the Savings and Loan industry.

Each of these differing major responsibilities is laudatory. All represent socially desirable goals. In seeking these goals, however, we must be sure that investors are protected and that securities fraud is exposed and minimized. This responsibility has been given to the Securities and Exchange Commission. We do not believe it should be divided among competing agencies because where that is done investor protection may well be relegated to a much lesser priority.

While the Commission does not favor S. 2628, which would provide a complete exemption from the Investment Company Act for SBICs, my comments about regulatory changes to remove present impediments on SBIC activities should leave no doubt that the Commission is very much interested in your problems. We welcome your suggestions and desire to work with you to bring about reasonable solutions. Our goal, of course, is to properly balance investor protection while providing minimum regulation and the degree of freedom necessary for proper SBIC operations. I believe we are rapidly approaching that goal.