TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES & EXCHANGE COMMISSION

CONCERNING SMALL BUSINESS FINANCE

BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

MARCH 26, 1992

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Dodd, Senator Gramm, Members of the Subcommittee: It is a pleasure to present my views regarding the importance of the Commission's proposed legislation to improve our current system of financing small business.

Small Businesses in Our Economy

There are almost twenty million small businesses in the United States, including 3.3 million corporations, 1.6 million partnerships, and 14.3 million sole proprietorships.[1] By another measure, there are over 6.2 million separate business enterprises, 99.8% of which (all but about 15,000 firms) have fewer than 500 employees.[2]

However they are defined and measured, it is clear that small businesses play a major role in our economy. Small businesses account for at least half of the entire U.S. gross domestic product. Although there are no statistics on "small business productivity," statistics on productivity in certain industries dominated by small

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[1] See Small Business Administration, The State of Small Business, at Table A.2 (Draft 1992 Report).

[2] See id. at Table A.3.

businesses, such as household appliance retailing, suggest that small businesses have achieved substantial productivity gains over recent years.[3] Small businesses also account for a substantial share of new technologies, and have created numerous entire new industries. Even a short list of examples of new technologies created by small businesses would include many of the most important inventions of this century.[4]

Firms with fewer than 500 employees employed over 57 million people in 1990, almost exactly half of total civilian, nonagricultural employment.[5] Between 1988 and 1990 small companies created, in the aggregate, more than 100% of all new jobs in the economy. Indeed, firms with fewer than 20 employees created slightly more than 4 million new jobs from 1988-1990, while firms with more than 20 employees lost, in the aggregate, slightly more than 1,350,000 jobs during the same period.[6] See Figure 1. Even over a much longer period of time, 1976 to 1990, on a weighted average basis small businesses accounted for 64.8% of all new jobs.[7] On average, almost two-thirds of U.S. employment growth in recent years has come from the birth of new firms, virtually all of which were small businesses.[8]

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[3] See Small Business Administration, The State of Small Business 24-28 (1990).

[4] See H.R. Rep. No. 349, 97th Cong., 1st Sess. 6-7 (1981).

[5] See Small Business Administration, The State of Small Business, at Table A.25 (Draft 1992 Report).

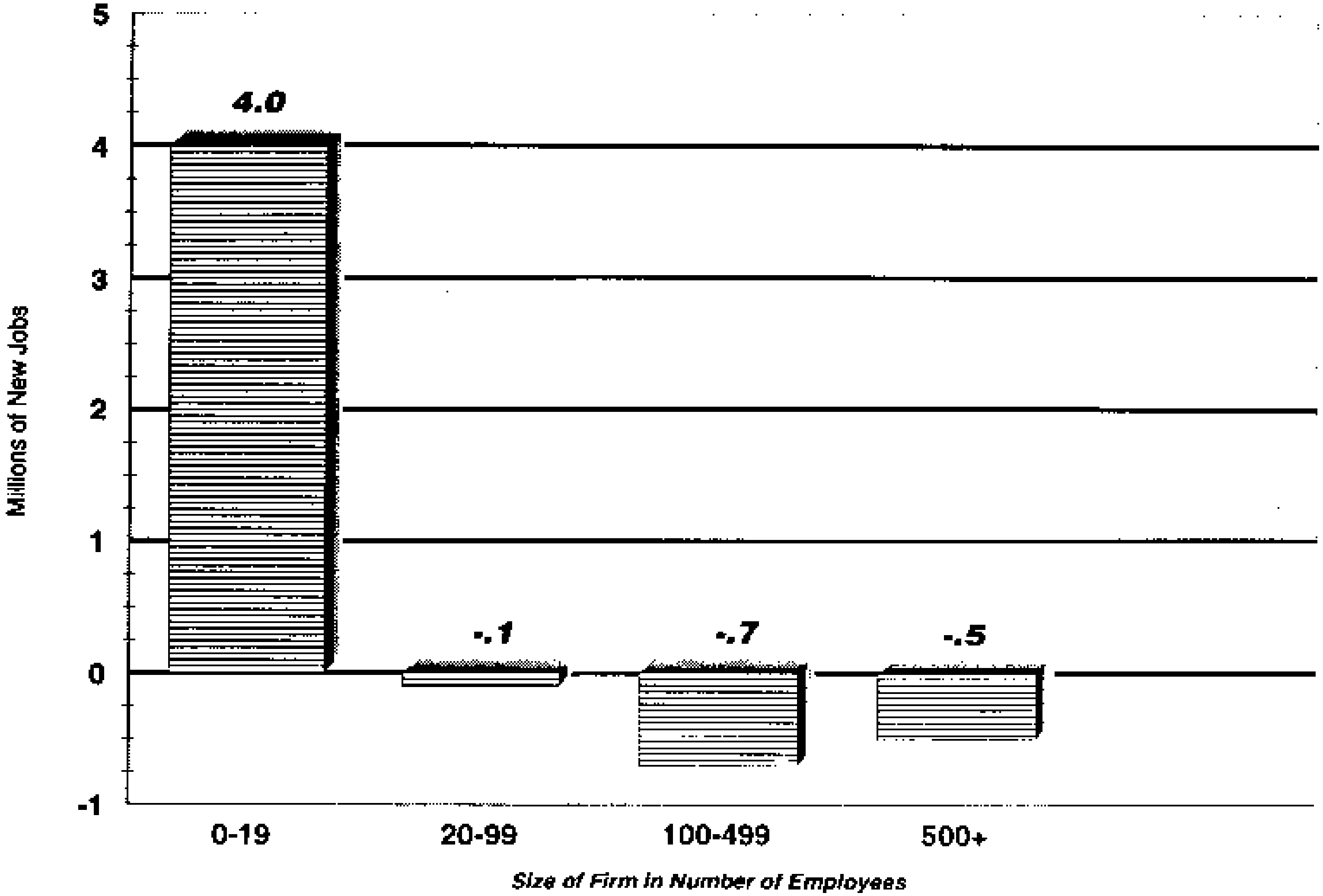
[6] See id.

[7] See id. at Table A.29.

[8] See id. at Table A.27.

Figure 1

Job Creation by Firm Size, 1988-1990



Source: Small Business Administration

Problems Facing Small Businesses.

The focus of this hearing is to consider proposals of the Commission to simplify the application of the federal securities laws to small business financing. However, at the outset it may be useful to note that problems of accessing public capital markets are not the most acute of all the problems confronting smaller firms. Indeed, in a recent survey of the members of the National Federation of Independent Business as to their single most important problem, 24% of the respondents cited "taxes," and 18% answered "government regulation."[9]

In addition to securities regulation, small businesses are subject to a vast and complex array of federal and state regulations. These include rules relating to many different types of environmental concerns, occupational health and safety, labeling and advertising, antidiscrimination, retirement plans and benefits, export control rules, and many others. Of course each of these regulations, and the statutes pursuant to which individual regulations are promulgated, may have an important social purpose. Hopefully, each regulatory program creates, in the aggregate, more benefits for society than costs. However, even where that is true, it must be recognized that the costs of regulation fall most heavily and disproportionately on small firms with fewer units of production across which to spread regulatory costs. Though not directly a regulatory cost, one of the most significant costs of small businesses -- providing health care benefits -- is certainly affected by governmental actions relating to health care.

In addition to the costs of regulation, owners of small businesses routinely cite taxes as the single most important problem facing their businesses. Recordkeeping

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[9] See National Federation of Independent Business Foundation, Quarterly Economic Report for Small Business 26 (Winter 1992).

requirements associated with the Internal Revenue Code create significant costs for small businesses that may fall more heavily on such firms than on larger firms. As entrepreneurs who take the very greatest risks in creating new firms, the owners of the original equity interests in such firms are also among the most directly affected by the absence of a lower rate of tax on capital gains, or any technique to prevent the taxation of that amount of gain represented by inflation. Most small businesses are unincorporated sole proprietorships whose income is taxed on an individual basis. Consequently, various tax benefits associated with the corporate tax system are not available to these small businesses.

Small Business Capital Formation

Capital -- the money to start and to expand -- is critical to any business, large or small. However, in addition to general regulatory and tax burdens, small businesses in recent times appear to have encountered more difficult problems in obtaining financing from traditional "pre-public offering" sources such as banks and venture capital firms.

Startup enterprises typically rely on the savings of the founder and friends or friends of friends. Once the capital of the founders is fully utilized, small business owners must find outside sources of investment. Typically many of the earliest outside investors in a small business are individuals who may have some informal contact with the owners of the firm through friends, family, or the local community. Though these informal investors are often individuals of relatively modest means,[10] their aggregate investments appear to be substantial in both nominal terms and as a percentage of

[10] See Gaston, Informal Financing of Small Business (1988).

total seed capital. Indeed, one study estimated the total capital infusions of such informal investors at $30 billion per year during the period 1982-1986.[11]

As a small business grows, it will have a steadily larger need for outside financing. Commercial banks and venture capital investors have typically provided the bulk of financing during the growth stage of a company prior to the stage of its being able to tap public markets through an initial public offering ("IPO").

Banks appear to have dramatically reduced their loans to small businesses in recent years. As shown in Figures 2 and 3, the total of outstanding commercial and industrial loans has declined about $30 billion in the past year alone, as well as falling even more steeply compared with overall bank asset growth.[12] At the same time that loans to all sizes of firms have sharply fallen, banks have reoriented their portfolios into holdings of much greater volumes of debt securities. See Figure 4. Indeed, had bank loans kept pace with growth in bank assets last year, almost $50 billion more in loans would have been made than actually occurred. See Figure 5.

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[11] See id.

[12] See Federal Reserve Bulletin, Dec. 1991, at A18 (C&I loans of $650.8 billion in December 1990); Federal Reserve Bulletin, March 1992, at A19 (C&I loans of $618.1 billion in December 1991).

Commercial and Industrial Loans Have Been Falling

Figure 2

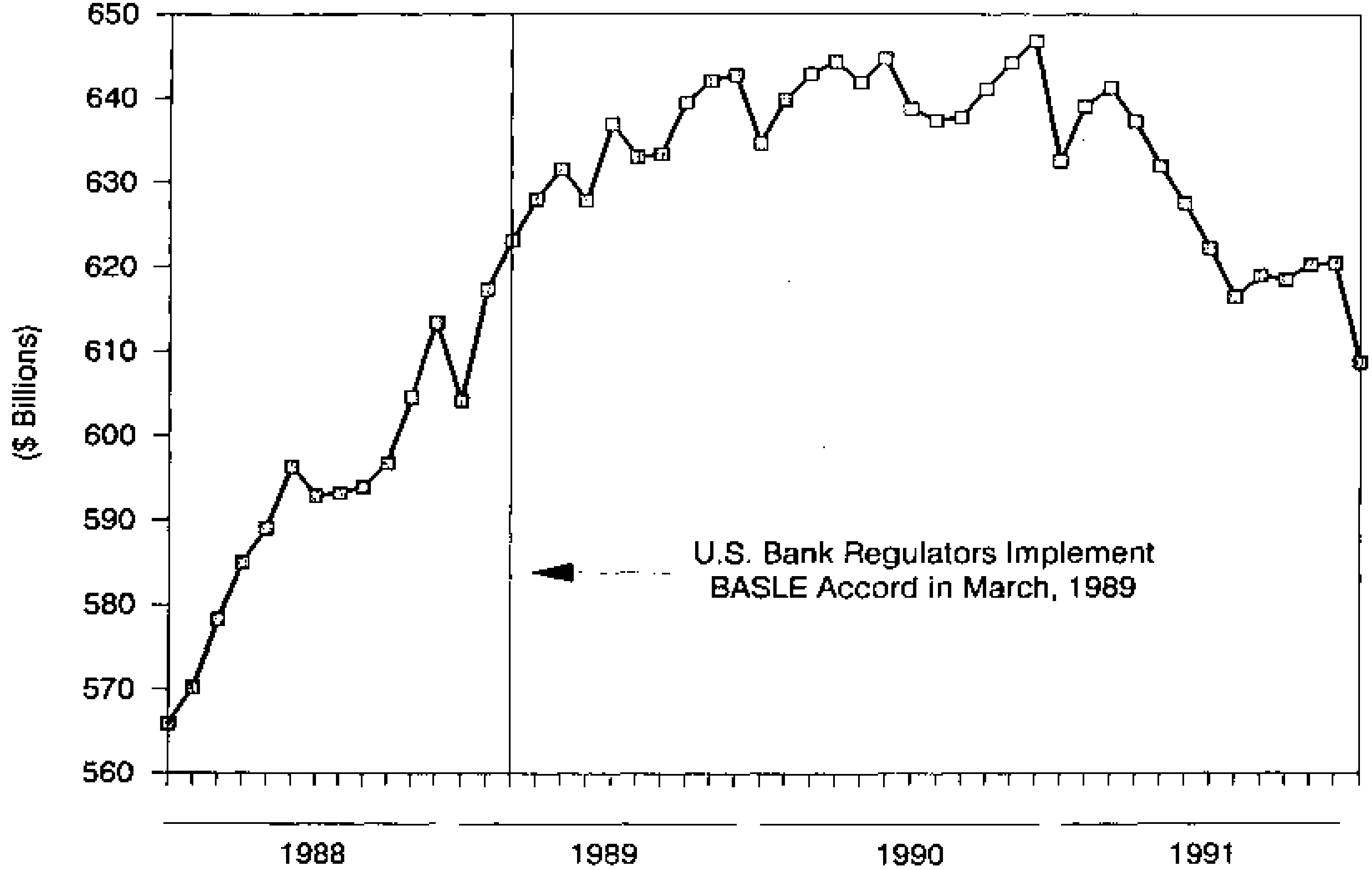
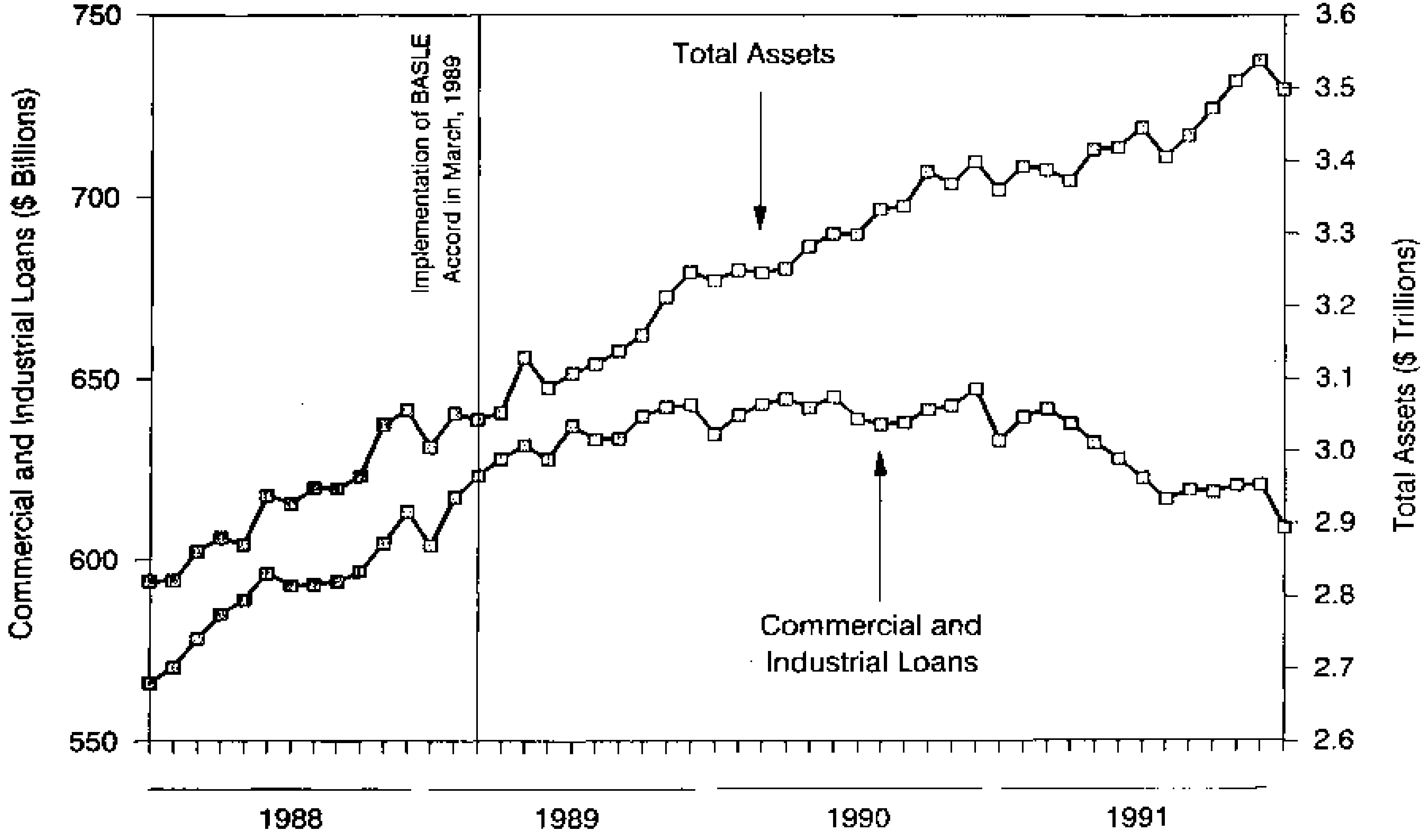


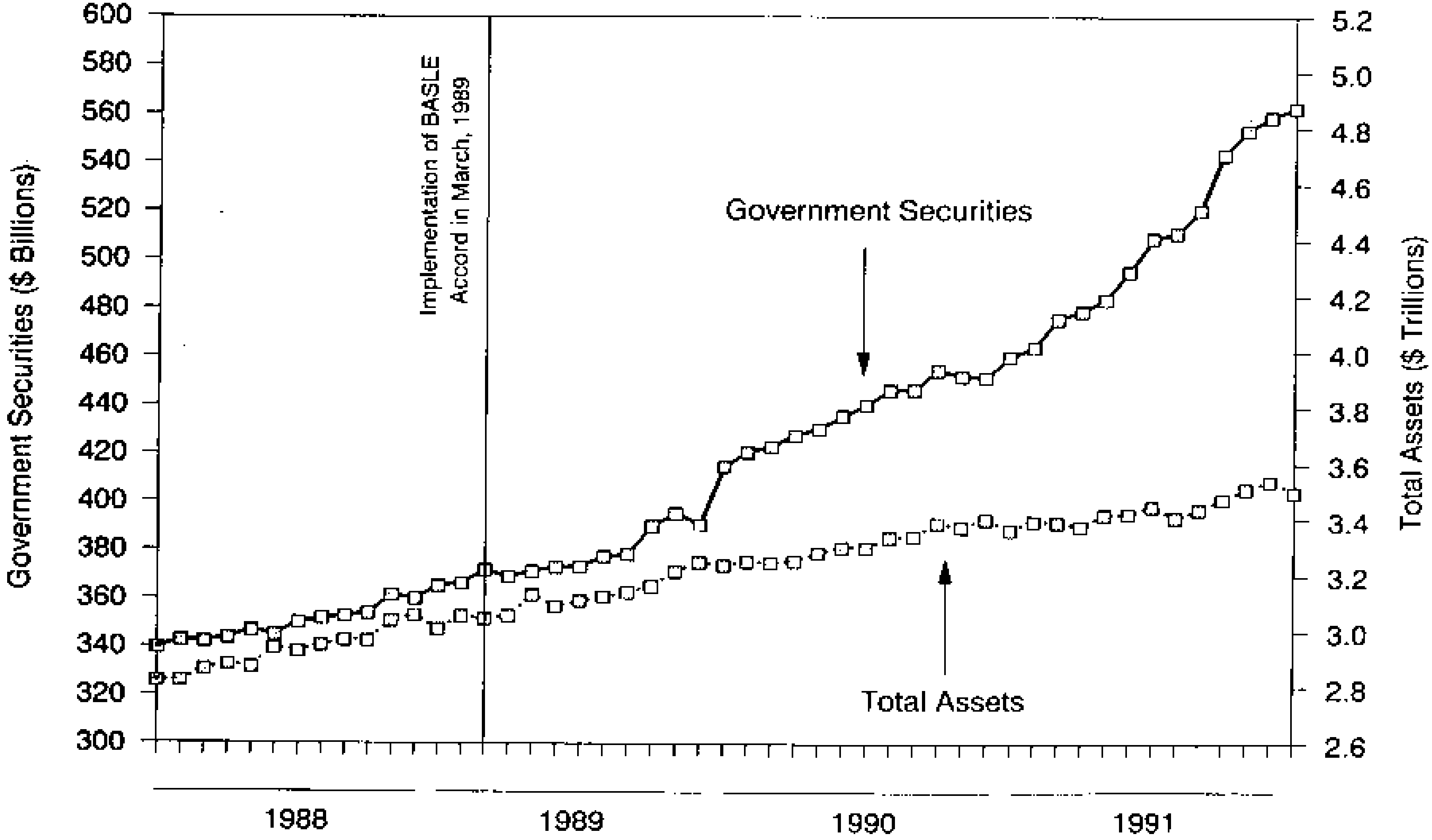
Figure 3

Commercial and Industrial Loans Have Declined While Total Bank Assets Have Increased

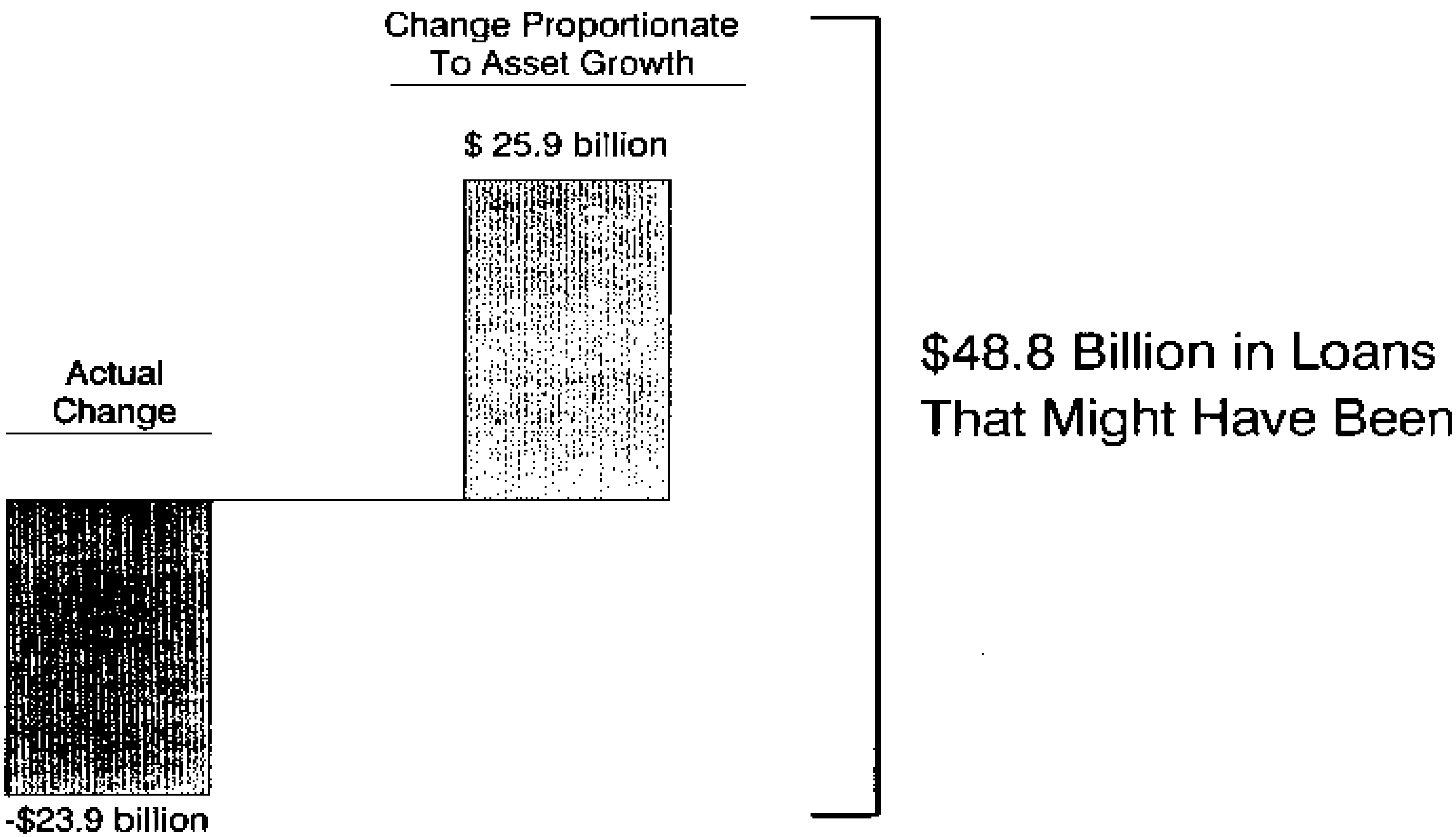


Holdings of U. S. Government Securities by Banks Have Increased at a Faster Rate Than Total Assets

Figure 4



Had bank loans kept pace with bank assets, loans would have grown $25.9 billion instead of falling $23.9 billion between January 1991 and January 1992.



Venture capital firms, another major source of finance for small businesses, also appear to have reduced their investments in recent years. New investments by venture capital firms in small businesses probably declined to less than $2 billion in 1991 -- less than one half of the $4 billion invested in 1987.[13] In addition, available venture capital funds may have swung away from financing the critical startup phase of small businesses. One survey found that the percentage of venture capital funds devoted to the startup phase of business fell from 44% in 1981 to only 11% in 1990.[14]

For large firms, a decline in the availability of financing through the banking system can of course be offset through more active use of securities offerings. During calendar year 1991 the aggregate volume of all types of securities offerings (public and private) rose by roughly 50%. As part of this surge in financings, in 1991, 359 firms raised over $16.4 billion through firm commitment initial public equity offerings. In addition, another 75 companies had SEC registration statements for other types of initial public offerings "go effective" in 1991. These registration statements represented another $1.6 billion worth of IPO securities.[15] In contrast, the volume of firm commitment IPOs for 1990 was only $4.6 billion. The rapid pace of IPOs has continued in early 1992. So far this year, over 120 firms have raised over $7.4 billion in

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[13] See Venture Capital Journal, July 1991 at 12 and Aug. 1991 at 20.

[14] See Venture Capital Journal, July 1991 at 12.

[15] These figures exclude securitized financings and offerings of limited partnership units or mutual funds.

firm commitment IPOs in less than three months.[16] Indeed, 1992 has thus already seen more IPO securities issued than during the full years 1988, 1989 or 1990. See Figure 6.

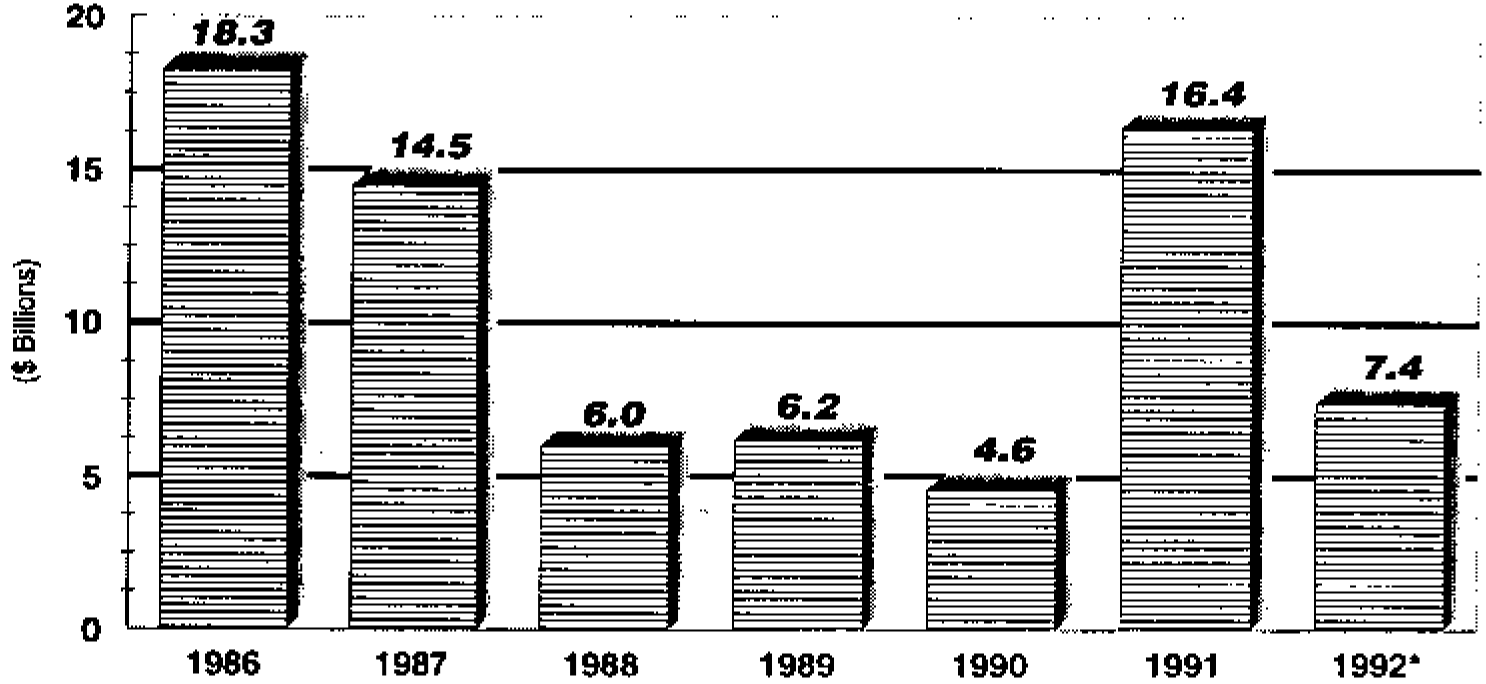
Some of the firms that raised capital through IPOs in 1991 were quite small. Indeed, 28 firms making an IPO had 1990 revenues of less than $1 million. Other IPO issuers were fairly large. In some cases (including representing reversals of earlier LBOs by larger companies), 15 firms conducting IPOs had annual revenues of over $1 billion. See Figure 7. The amounts raised were similarly varied, ranging from less than $100,000 to $689 million.

These IPOs are not only providing financing for the companies involved, but indirectly stimulating financing for hundreds of other companies, by encouraging venture capital firms and others to invest in startup businesses. However, the availability of significant funding through IPOs does not directly address the financing needs of firms that are too small to be able to conduct a traditional IPO.

[16] See Wall Street Journal, Jan. 3, 1992; Wall Street Journal, March 19, 1992, at C1.

Figure 6

Firm Commitment Initial Public Equity Offerings

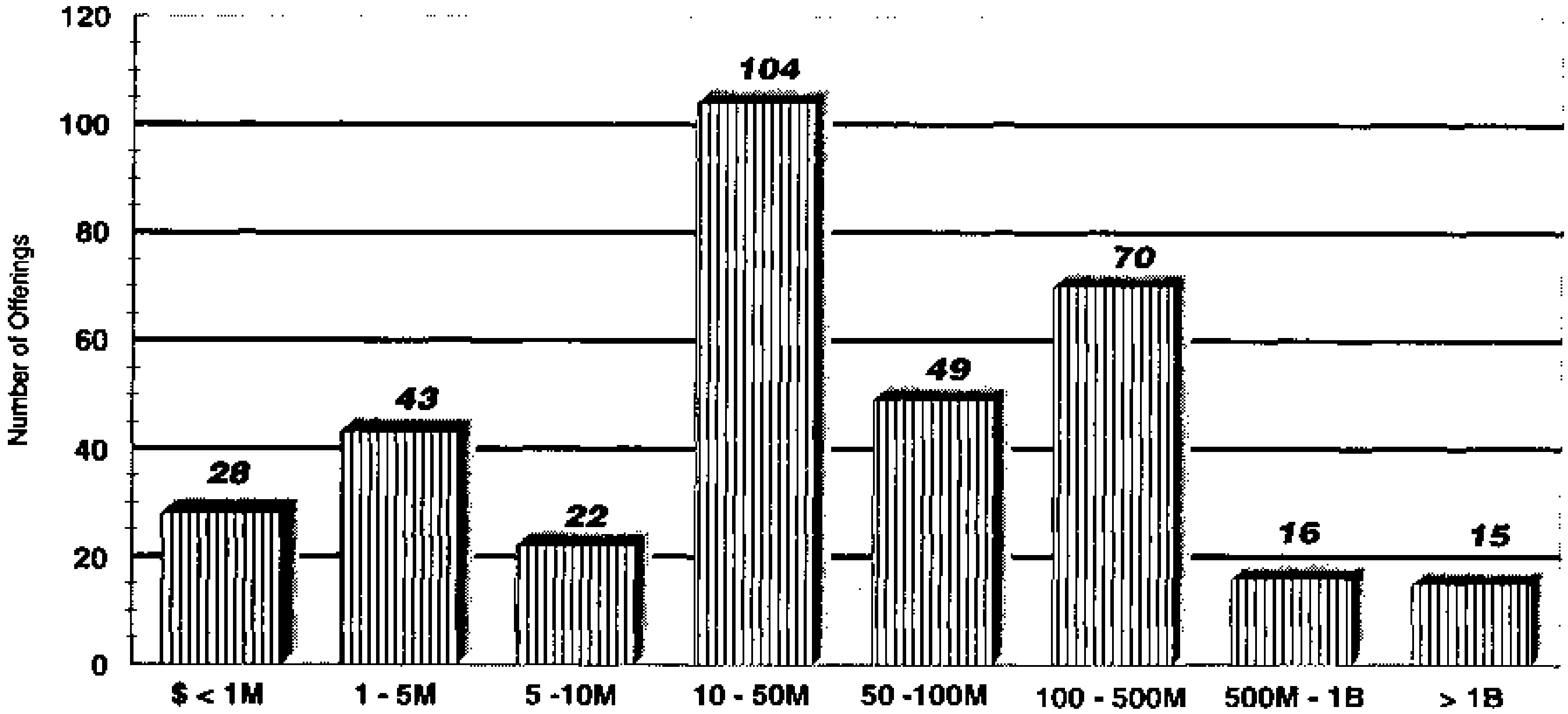


* Year to date (to March 19)

Source: IDD Information Services, Inc.

Figure 7

1991 IPOS By Revenue of Issuer



Annual Revenues of Company for 1990

Source: IDD Information Services

The SEC's Role in Small Business Finance

The Commission is primarily responsible for protecting the fifty million people who have invested their savings in this nation's securities markets. We are also responsible, however, for creating an efficient regulatory process for the issuance of securities into U.S. capital markets. An important part of this second responsibility is ensuring that the securities laws do not unduly or unnecessarily impede securities sales by small businesses.

Congress has directed the Commission, to the extent possible, to reduce securities law costs for small businesses. Indeed, in the text of the original Securities Act in 1933, Congress allowed for regulatory exemptions of offerings of up to $100,000 from the registration requirement. Congress has increased this limit several times "to assist small business in raising capital."[17] In the Small Business Capital Formation Act of 1980, Congress directed the Commission to "use its best efforts" to "reduce the costs of raising capital" for small businesses.[18] That Act also required the Commission to work with the state securities authorities to increase uniformity in state and federal regulation and to reduce regulatory "costs and paperwork," particularly for small businesses.[19] The Commission's current legislative and regulatory proposals reflect both the letter and the spirit of these Congressional directives.

These proposals reflect several other considerations. These include:

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[17] S. Rep. No. 763, 95th Cong., 2d Sess. 7 (1978).

[18] 15 U.S.C. § 80c-3.

[19] 15 U.S.C. § 77s(c)(2).

<u>First</u>, the protection of investors against fraud and other forms of marketplace abuse remains the essential core of any specific regulatory arrangements for registering securities. Every legitimate business, large and small, has an interest in seeing the Commission continue its efforts to prevent fraud and deceit in the sale of securities. In this area it is important to recognize that it is easier to commit some types of fraud, such as market manipulation, with the securities of a company with a small total market capitalization than with the securities of a company with a large market capitalization. In addition, stocks of companies with a long history of widespread disclosure of financial information may be more difficult to manipulate than stocks of companies with a shorter history or less widely distributed financial information. Thus, with or without simplification of the offering documents themselves, investors and regulators will need to consider disclosures carefully, and to remain alert to signs of fraudulent activity.

<u>Second</u>, disclosure of material facts about the company and its business is a vital protection of investors. Over the years, disclosure mandates have become complex, and disclosure practices have often become too legalistic. The prime beneficiaries of undue complexity are lawyers, not investors. The prime victims of undue complexity are small businesses, who simply cannot afford legal and accounting bills of $100,000 to $200,000 for a registered securities offering. The Commission takes very seriously the need to clarify and simplify our requirements so that good disclosure is not obscured by heavy encrustations of legal boilerplate.

<u>Third</u>, very small businesses that are not yet ready for an initial public offering need the ability to raise capital through small, less costly, exempt securities offerings. The Commission has attempted to approach this problem both from the perspective of

the company -- through proposals such as our simplifications of Regulation A and Rule 504 -- and from the perspective of institutional investment -- since private venture capital firms often provide critical financing in the years before an initial public offering can realistically be considered.

Fourth, the development of a securitized secondary market for pooled obligations of small business may ultimately prove to be the most important step to be taken. Securitization -- the process of pooling debts and turning them into securities -- has revolutionized the home mortgage market. It has also been used to distribute interests in credit card receivables, car loans, aircraft leases and many other types of financial receivables. Often (though not always) such securities utilize some type of "credit enhancement," such as a guarantee, over-collateralization, puts or other devices. Securitization of small business debt would allow banks and other originators of credit for small businesses to obtain liquidity by selling those instruments as part of a package of smaller obligations. In this manner banks would not be constrained by capital requirements from originating loans to otherwise creditworthy borrowers. This would also create a new instrument for investors willing to invest in the pooled debt of many small businesses.

The Small Business Incentive Act of 1992

The basic purpose of the Small Business Incentive Act is to make it easier for small businesses to sell their securities, and easier for investors to buy such securities, without reducing critical investor protections. Since the link between the legislative language and small business is not always obvious, it may be useful to explain how the specific proposals would help small business, and why they would not endanger investors.

Securities Act Exemptive Authority. Section 101 would increase from $5 million to $10 million the Commission's authority to exempt offerings from Securities Act registration. The Commission has used this authority to create several exemptions from the registration requirement, including Regulation A (an exemption for small public offerings), Rules 504 and 505 (two exceptions for limited offerings), and Rule 701 (for employee benefit plans).

Increasing the Commission's exemptive authority under Section 3(b) to $10 million would allow us to extend the benefits of this approach to more small business financings. In drafting or granting exemptions under this authority, the Commission would presumably continue to impose investor protection limits appropriate to the size and type of the offering. Investors would also continue to be protected by the antifraud provisions of the Securities Act and the Exchange Act, which prohibit materially misleading statements or omissions in connection with any sale of securities.

Private and Qualified Investment Companies. Private investment companies have provided substantial capital for small businesses. Between 1981 and 1990, private venture capital firms invested over $25 billion in thousands of small businesses.[20] Most of the investors in these venture capital firms are substantial and sophisticated. Major pension funds, insurance companies, corporations, private foundations and endowments are among the types of such investors, along with high

[20] See Venture Capital Journal, July 1990 at 14 and June 1991 at 14.

net worth individuals.[21] Under current law, however, a venture capital fund cannot have more than 100 investors, irrespective of how sophisticated they are, without triggering the application of the Investment Company Act of 1940 and all its very detailed requirements designed largely to protect retail investors in mutual funds and similar organizations. In addition to creating unnecessary regulatory costs, application of the Investment Company Act could impose restrictions -- such as restrictions on capital structure -- that would make operation of a venture capital fund impracticable. Moreover, current rules substantially and unnecessarily limit investments by corporations and registered investment companies in private venture capital funds.

Section 201 would create a new exception in the Investment Company Act for investment pools whose securities are held exclusively by qualified purchasers. Qualified purchasers, under Section 202, would be defined by the Commission on the basis of financial sophistication, net worth and other relevant factors.[22] These sophisticated investors would be free to participate in investment pools that are not subject to the requirements in the Investment Company Act designed for the retail investing public. This statutory provision should tend to increase the flow of funds into venture capital companies, and thereby from venture capital companies into small businesses.

Section 203 of the Act would simplify the attribution and anti-pyramiding rules in the current private investment company provision to facilitate participation by corporate

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[21] See Venture Capital Journal, August 1990 at 14.

[22] At least initially, the Commission would probably define "qualified purchaser" under this section more or less as it has defined "qualified institutional buyer" under Rule 144A under the Securities Act.

investors and registered investment companies in private investment companies. This change would allow a mutual fund or a corporation to invest in a private venture capital fund investing in small growth companies without requiring the venture capital fund to register as an investment company. Of course where a mutual fund invested in a venture capital fund, the investing mutual fund would remain subject to the Investment Company Act. Investors would remain protected by the other provisions of the Investment Company Act, as well as the disclosure and antifraud requirements of the Securities Act and Exchange Act.

BIDCOs and Intrastate Investment Companies. At least 45 states have authorized the creation of a "business and industrial development company" or "BIDCO," to provide investment capital (and in some cases managerial assistance) to businesses within the state. Under current law, these BIDCOs must register their securities with the Commission under both the Securities Act and the Investment Company Act, though some exemptions may be available under the Securities Act. In addition, the Investment Company Act has since its inception authorized "intrastate" investment companies whose investors are drawn from only one state. In both cases, the relevant state has a strong interest in protecting its resident investors.

Section 205 would exempt BIDCOs that meet certain requirements designed to ensure a close connection with a single state from most provisions of the Investment Company Act. Section 206 would increase from $100,000 to $10 million the amount of securities that could be issued by an exempt intrastate investment company. These exemptions should make it less costly to form and expand these "single state" investment companies, and these companies should in turn provide critical capital for small, local businesses. These exemptions would not remove any of the normal protections of federal disclosure and antifraud requirements under the Securities Act and the Exchange Act. Investors would also continue to be protected by state securities laws.

Business Development Companies. "Business development companies" or "BDCs" are a special type of public investment company investing in, and providing managerial assistance to, small businesses. Although they were conceived of as a "public" alternative to private venture capital companies, BDCs have not proved particularly popular. There are only about 40 active BDCs with assets of only about $2.4 billion. By way of contrast, there are over 600 active private venture capital companies with assets of over $36 billion.[23]

Sections 207 through 210 of the proposed legislation would make various changes to make it easier and less costly for BDCs to offer securities and to make investment in small businesses. For example, the Investment Company Act currently requires a BDC to invest at least 70% of its assets in small businesses, and to make available "significant managerial assistance" to all the companies used to satisfy this 70% test. Section 208 would amend the Act so that BDCs could invest in, without necessarily providing managerial assistance to, a new category of very small companies. Many small businesses may need finance, but not managerial assistance, and this would allow BDCs greater flexibility to invest in these companies.

The proposed BDC changes should not create new "regulatory" risks for investors, who would still be adequately protected by other provisions of the Investment Company Act, as well as by the Securities Act and Exchange Act. Of

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[23] See Venture Capital Journal, April 1991 at 12-13.

course, these statutes do not protect investors against the risk that BDC securities may decline in value if the BDC's investments prove unsuccessful, but that market risk is one that already exists today.

Taken together, the Commission believes that the provisions of the Small Business Incentive Act would prudently expand the ability of smaller businesses to raise capital in securities markets directly. It would also improve flexibility for venture capital funds and other pooled investment vehicles without impairing investor protections. The Commission strongly recommends enactment of this legislation.

The SEC's Small Business Regulatory Proposals

In addition to developing these legislative proposals, the Commission has also recently proposed changes to our regulations under the Securities Act, the Exchange Act and the Investment Company Act to facilitate small business capital formation. A brief description of these regulatory proposals may be useful to the Subcommittee as it considers the legislation.

To make it easier for small businesses to raise capital without incurring substantial legal and offering expenses, the Commission has proposed revisions to Regulation A. That regulation provides an alternative to the expense of a registered initial public offering and the limitations of a private offering. Although Regulation A was quite popular ten years ago -- there were 439 Regulation A filings for a total of $408 million in fiscal year 1981 -- it is rarely used now. In fact, there were only 44 Regulation A filings for $34 million in calendar year 1991.

Regulation A offerings are substantially easier and simpler than registered offerings. Regulation A does not require certified financial statements, and it requires a less detailed description of the company's business. Although statements made in a Regulation A offering are subject to the antifraud rules, they are not subject to the "strict liability" of Section 11 of the Securities Act. An offering pursuant to Regulation A does not create a continuing reporting obligation under the Exchange Act, while a registered offering generally subjects a company to annual, quarterly and other reporting requirements.

The Commission's proposal would increase from $1.5 million to $5 million the amount that a small business could raise under Regulation A in a single year. This would utilize all of the statutory exemptive authority of the Commission under current law. This higher limit would in part reflect inflation since 1978, when the current limit was established. Indeed, if the Commission's proposed legislation is enacted, the Commission would consider a further increase in the limit for offerings utilizing Regulation A.

In addition to increasing the limit for "Reg A" offerings, the Commission has proposed to allow a firm contemplating a Regulation A offering to "test the waters" for investor interest. This would involve allowing the firm to use a letter, brochure or other simple document that contained factual information about a company as a means of determining the level of investor interest in the company's securities. A large firm, with an established secondary market, knows that there is investor interest in its securities. A small firm, which has never sold its securities, does not know whether there is investor interest, and thus does not know whether it is worthwhile to spend significant amounts for lawyers and accountants for a securities offering. This proposal would allow small firms to acquire some information about investor interest before incurring these expenses.

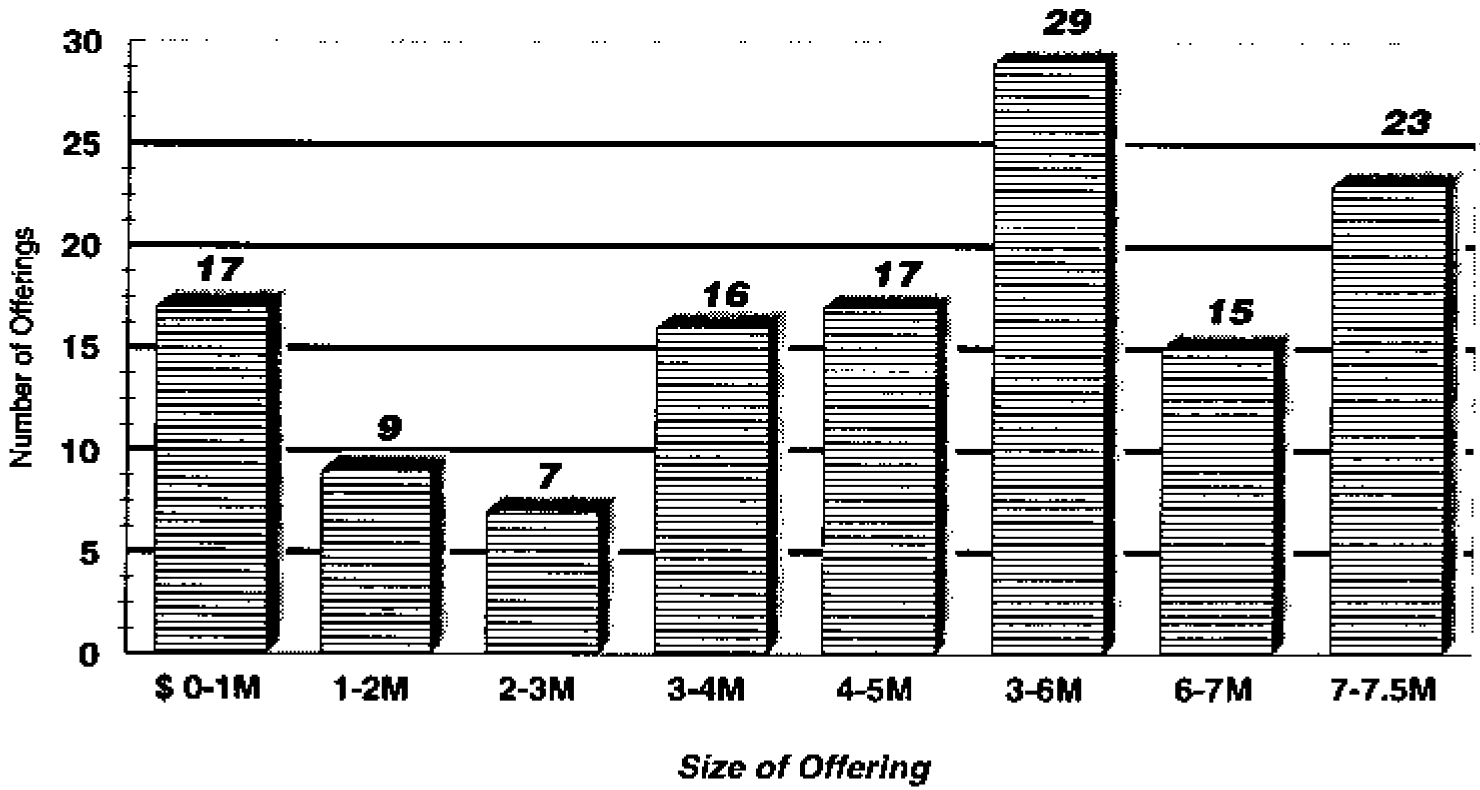
Finally, the Commission's proposal would give firms the option of using a simple question and answer form developed by the state securities regulators as the actual Regulation A offering document. By adopting this form now used in over 20 states, the Commission would both harmonize federal and state offering document requirements and reduce to some degree the cost of preparing the necessary filing documents.

Another proposal would expand the use of the Commission's existing Form S-18, which is a streamlined form for registering small IPOs. During 1991, Form S-18 was used by 133 firms to register $597 million worth of equity securities. See Figure 8. Form S-18 requires only two years of financial statements prepared in accordance with generally accepted accounting principles ("GAAP"), rather than three years of financial statements prepared in accordance with GAAP and the Commission's accounting rules. Form S-18 is only available, however, for IPOs or follow-up offerings in the same year of up to $7.5 million.

Under the proposal, a new offering form, Form SB-1, would be available for any offerings by businesses with annual revenues of not more than $15 million. These same small businesses could also use a new series of "small business" forms, called 10-KSB and 10-QSB, for their periodic reports under the Exchange Act. All of these forms are designed to be both easier to complete and easier to read than the current forms. These new forms should not result in reductions in the overall quality of the information available to investors. Indeed, if anything the simpler format may make it easier for investors to find and appreciate the information they need.

Figure 8

1991 Equity Offerings on Form S-18



Source: SEC Data

Under the Investment Company Act, we propose to increase from $5 million to $15 million the amount of securities that a Small Business Investment Company ("SBIC") could offer under Regulation E in a single year. We also propose to increase, from $100,000 to $1.5 million, the amount of SBIC or BDC securities that can be offered each year under Regulation E by a selling shareholder other than the issuer.

Another change, already implemented, has increased from 10% to 15% the percentage of illiquid assets, like small business securities, that an open-end mutual fund can hold. This should allow mutual funds that are interested to purchase, to some extent, the securities of small businesses that are not yet publicly traded. Given the substantial cash reserves mutual funds typically maintain, and the requirement that 85% of each fund's assets be in liquid investments, this change should not create any real risk for mutual fund investors.

Another proposal would amend Rule 504. The proposal would allow companies not yet registered under the Exchange Act (generally smaller companies that have not yet conducted an initial public offering) to offer up to $1 million of unrestricted securities each year without federal registration and without a federal requirement that the offering be registered with the relevant states. Currently, unless the securities are registered in the states, they may not be freely transferred by the investor. In addition, the issuer would not be allowed to engage in a general solicitation and would be limited to offering $500,000. Companies relying on Rule 504 would still be subject to the antifraud and civil liability provisions of the Securities Act and Exchange Act. Given the very modest size of these offerings, it seems appropriate to rely more upon antifraud rules, and less upon more detailed and expensive registration requirements, for investor protection.

Securitization

All of these changes -- legislative and regulatory -- are important. Perhaps the most significant change of all, however, would be to create a framework for securitizing small business debt. Securitization has revolutionized the home mortgage market. In 1969, there were no securitized home mortgages. In early 1992, there are over $1.2 trillion worth of home mortgage securities outstanding, representing over 42% of all one-to-four family home mortgages.[24] Securitization has undoubtedly resulted in lower interest rates for homeowners. Securitization has also allowed banks and thrifts to originate home mortgage loans without holding such loans on the institution's books or having to provide permanent funding for the loan. This has made the mortgage market largely resistant to funding shortages:

> In the 1974 credit crunch, home buyers could not get a mortgage anywhere because the banks were strapped for funds and had nothing to spare for mortgages. In 1991, amid a nationwide recession and local real estate depressions, mortgages were readily available because banks knew that, immediately after originating home loans, they could sell them off for repackaging. Without that wave of securitization, the 1991 credit crunch might well have been billions of dollars worse.[25]

As you know, the securitization of home mortgages has involved a very active and central role for the Federal National Mortgage Corporation, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association. Some have suggested the creation of a new GSE or the availability of a government

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[24] Federal Home Loan Mortgage Corporation, Database, The Secondary Mortgage Markets, Winter 1991/92, at Table 5.

[25] Forbes, March 30, 1992, at 63.

guaranty to encourage securitization of the debt of small businesses.[26] GSEs have clearly served an important role in creating the terms and techniques used to securitize home mortgages, although private firms rather than GSEs have been involved in the securitization of many other types of financial assets.

A new GSE for small business loans, however, could have serious disadvantages. To the degree that the existing GSEs are perceived to carry an implicit government backing that does not exist explicitly, creation of yet another such entity could add to the volume of securities as to which there may be an implicit taxpayer contingent liability.[27] A new GSE could also displace fully private market participants and reduce the range of experimentation that might otherwise occur.

A GSE has not been necessary to securitize billions of dollars worth of credit card receivables, automobile loans, boat loans, airplane leases, computer leases, and accounts receivable. During 1991, over $50 billion worth of such asset-backed securities were created in 104 transactions. The most commonly securitized assets were credit card receivables (32 transactions involving $21 billion) and automobile loans (33 transactions involving $16 billion).[28] As of the end of 1991, over $158 billion worth of non-mortgage asset-backed securities had been issued.[29]

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[26] E.g., Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises: Hearing on H.R. 3179 Before the House Comm. on Small Business, 101st Cong., 1st Sess. (1989).

[27] See, generally, Congressional Budget Office, Controlling the Risk of Government-Sponsored Enterprises (1991); Department of the Treasury, Report on Government-Sponsored Enterprises (1991).

[28] Dean Witter Reynolds, Asset Backed Securities at A-10 (1992).

[29] See id. at A-16.

To some extent, loans to small businesses are already being securitized. The Small Business Administration ("SBA") has an excellent program for securitizing the portion of small business loans that the SBA has guaranteed. This program has permitted more banks to make more SBA loans and created a guaranteed, small business security for investors. The Resolution Trust Corporation, in two current transactions, is securitizing over $900 million worth of commercial loans. Depending upon how one defines "small business," many or perhaps most of these commercial loans were originally loans to small businesses backed by mortgages.

One problem facing those seeking to securitize small business loans is the absence of a suitable exemption from the Investment Company Act. Securitizations simply cannot proceed under the regulatory and corporate governance requirements of the Investment Company Act. In most cases, those structuring an asset securitization are able to find an appropriate exemption from the Act, such as the exception for companies holding real estate and mortgages or the private investment company exception. In some cases, however, an exception is not available, even though the transaction poses no more risks to investors than the standard mortgage-backed, highly-rated securities. Under current law, it is particularly difficult to securitize small business loans that are not secured by a mortgage or receivables.

The Commission is therefore working to develop a more flexible exception from the application of the Investment Company Act for high grade asset-backed securities. The proposed exception will be carefully drafted and designed to avoid any undue risk to investors. The proposed exception should substantially simplify the process of securitizing small business loans, especially those not backed by mortgages or receivables. A related proposal in progress would extend the benefits of shelf registration now available to mortgage-backed securities to all structured financing transactions. This, too, is an important step in simplifying the process of securitizing small business loans, as well as other types of assets. In developing these proposals the goal is not to replace or displace the SBA and its loan and securitization programs, but rather to facilitate the development of a new private market for securities representing pools of loans to small businesses. In time these proposals could allow billions of dollars of small business loans to be made more liquid, thereby improving the availability of such loans and reducing their cost as has proven to be possible in other markets.

Conclusion

Small businesses are not only part of an agrarian, small-town American past. Small businesses are part of the American present, and even more importantly the American future. To play their part, though, small businesses need capital. The Small Business Incentive Act of 1992 would make it easier for small firms to raise capital, and for investors, directly or indirectly, to invest in small firms. The Commission's regulatory proposals that are now out for public comment should serve the same ends. At the same time that we seek to find even better ways to simplify small business capital formation, our dedication to maintaining the quality of investor protection, as well as the availability of reliable, relevant and comparable information for investors, remains unswerving.