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AT THE PUBLIC HEARING
OF THE SECURITIES AND EXCHANGE COMMISSION
ON THE EFFECTS OF ITS RULES AND REGULATIONS
ON THE ABILITY OF SMALL BUSINESSES TO RAISE CAPITAL
APRIL 12, 1978

Mr. Chairman and members of the Commission, I am pleased to express my views on the impact of the Commission's requirements on the financing of small businesses. The Commission is to be commended on holding these hearings. Your announcement of these hearings shows that much thought has gone into preparing for them.

I will not specifically address the 75 questions suggested for comment. Other witnesses and the staff have more current and specific experience than I on how detailed steps suggested by these questions can best be implemented without impairing investor protection. I have to express the view that these improvements in disclosure and reporting requirements, while helpful and affording needed relief, only nibble at the edges and do not adequately address the grave national problem of restoring the availability of equity capital to new and growing businesses. I believe that bolder and broader steps are necessary to revitalize this innovative and creative segment of our economy, and I'm here to urge the Commission to make no small plans.

There's something wrong with a national policy which unduly inhibits offering a business risk to experienced investors who think they can afford it, while it encourages the general public, at any newsstand or drug store, to risk $17 billion a year in government-sponsored lotteries in which there is a guaranteed loss of 20% or so of the people's savings.

I am confident that this Commission and its staff has the ingenuity and the resourcefulness to restore,with needed investors protection, the flow of $1 billion a year which during 1968 and 1972 went into these enterprises with full registration yet, as experience showed, without adequate investor protection.

The flow of risk capital has been restricted by a number of factors -- tax disincentives, a weak and declining stock market, the impact of inflation on savings and on business profits, the impact of ERISA on institutional investment policies, as well as some SEC rules.

I believe it is urgent to jobs and opportunity and price stability and, yes, to the quality of life here in America and to our competitiveness in the world that we unclog and strengthen the channels between individual and institutional savings and new and growing businesses.

To accomplish this I suggest we will have to differentiate between investments made by the general public through the public securities markets and those made by sophisticated investors through private channels. This is a distinction contemplated by the securities laws when enacted, but all but obliterated over the last decade and a half by trying to provide the same protection for all investors. I believe it necessary to develop a new and more workable approach based on

distinguishing more sharply between the large mass of investors who need special protection and those who are reasonably able to protect themselves. Let me suggest some principles for your consideration:

1. The general public should be encouraged to invest in seasoned companies which analysts can appraise from past performance and by research into the present situation and future prospects of the company and its industry, its market and its technology.

2. New and unseasoned companies should look primarily to sophisticated private and institutional investors, including specialized venture capital pools, who can evaluate and bear the kind of risk these companies represent.

3. The present system should be revised to make this private route less uncertain and cumbersome and less discouraging to new companies needing financing and to investors prepared to accept the economic risks in unseasoned businesses.

4. In the private financing of small companies, there should be less reliance on registration for investor protection and more on requiring the investor, with the backing of the anti-fraud rules, to assume responsibility for obtaining the information he thinks he needs.

5. As these privately financed enterprises mature, the Commission's continuous disclosure system should be relied on to provide both investor protection and liquidity to existing investments.

The major sources of equity funds should be looked at separately to understand what is needed to make them more inclined to resume the financing of small businesses.

I break these sources down into four groups:

1. The savings of individuals put into the public securities markets;

2. The savings of individuals dealing with new and small businesses on a private or local person-to-person basis;

3. Professional venture capital pools;

4. Savings accumulated in pension funds, life insurance companies and other institutions.

Financing sources in the second and third categories and, to a limited extent, those in the fourth, are best suited to narrow and bear the risk of investing in new and unseasoned companies. The dividing line between these different sources of financing is not always clear. Their ability to evaluate and bear risk is quite different yet the tendency over the years to impose on each of them Procrustean restrictions, which are often unsuitable and unintended, is a big part of the problem we have today.

Raising money in registered public offerings has become prohibitively expensive for small companies. The less expensive Regulation A filing has become increasingly unattractive. The half million dollar limitation means that very few, if any, underwriters can afford to be interested. This in turn means that most issues are self-underwritten. The issuers who are not frightened away by this responsibility are usually unable to sell more than a fraction of

the issue. Both lawyers and underwriters are unhappy with the absence of audited financials. There is a wide-spread perception on the part of underwriters and professionals and investors that Regulation A provides second-class protection. Therefore, I believe that the Commission, in developing the S-18 form of registration for small companies with its combination of hopefully speedy processing in the regional offices and audited financials, has taken a step which can provide important temporary relief but needs to be followed up by more fundamental measures.

History tends to repeat itself, and we are likely to see at some point a revival of public interest in new and smaller companies. The SEC's hot issues hearings in 1972 clearly demonstrated that registration of these offerings is no panacea. Indeed, if we learned anything from the hot issue trauma of the late sixties, it was that the registration process for small issues may permit as many abuses as it prevents. When an unseasoned venture is registered, it becomes available and saleable to unsophisticated investors. Those least able to afford it are also least able to resist the combination of speculative fever and hard sell that may be both encouraged and insulated by the existence of an effective registration statement. Even with the additional disclosure requirements that came out

of the hot issue study, registration alone is unlikely to protect small investors from salesmen ranging far and wide with optimistic forecasts in bullish phone calls. This hard sell is less likely where an issuer is trying to bring its offering within the intended "safe harbor" of Rule 146.

Although the registration process is capable of providing the kind of information needed to evaluate new ventures and unseasoned businesses, it frequently does not and it often becomes a hunting license encouraging open season on investors who can neither assess nor afford the risk, while it turns off those who can. The kind of information that experienced investors demand and get in a private placement is quite different from that normally found in a prospectus. The experienced investor wants to know not so much about the past as about expectations for the future and the basis for them. For years, while the SEC was prohibiting projections in registration statements, many if not most registered securities were being sold on the basis of estimates and recommendations delivered on the telephone; the reliability of these estimates and the suitability of accompanying recommendations has tended to fluctuate widely. By contrast, the typical private offering memorandum is likely to pin the offeror to a definite set of expectations. Indications of planning and budgeting, which are likely to appear in a private disclosure document and to be disavowed in a registration statement

can enable sophisticated investors and venture capitalists to assess the quality of management. Rule 146 has been at least partially successful in providing an alternative to costly registration of small offerings. It can be made less technical and less cumbersome and more useful to sophisticated investors and, in response to the Commission's request, valuable suggestions have been submitted to achieve that.

Many valuable job creating, foreign exchange earning ventures get under way in this country by a pooling of the efforts and savings of a small group of people and by friends and neighbors putting up money to back a budding entrepreneur. As the document issued by the Commission to define the issues to be considered here stated: "The legislative history reveals that the Congressional purpose underlying the intrastate exemption was to permit local financing of companies primarily intrastate in character without registration." It was thought that by restricting the offering to persons who are within the same locality as the issuer the protections afforded by registration would not be needed since, by virtue of their proximity, they would be likely to be familiar with the issuers and protected by the governing state law.

Yet, the Commission's rules have used a shoe horn to squeeze intrastate offerings into a registration box, requiring registration no matter how local the source

of financing if as much as one investor or 20% of the issuer's product can be traced out of state. Certainly this restriction can and should be reviewed to bring it closer to the original Congressional intent.

We have seen the same narrowing of the private offering exemption through judicial rulings under the influence of the legal skill and persuasiveness which the Commission's counsel have always displayed. But certainly, the law does not intend that a handful of people banding together in a business venture would have to register under penalty of giving any one of them a legal right to welch on a deal they had made together. Yet, that is the practical result of the virtual disappearance of the private offering and intrastate exemptions.

Rule 146 or any other form of unregistered offering will never be sufficient to bring in capital by offerings to limited numbers of investors as long as the restrictions in Rule 144 remain as stringent as they are.

Frequently, a private placement with a professional investor capitalist or institutional investor is the only source of funds which is appropriate or available. The professional venture capital industry has assets of a billion and a half and invests about $100 million

a year which is more than the public market has put into small companies in recent years.

These professional venture capitalists have been increasingly staying away from start-ups and young businesses, using their funds instead to take positions in established companies. Only four percent of their investments go into start-ups, and only two percent into first-round financings -- a sharp decline from previous years. More and more of them have established a policy of avoiding start-ups by requiring an earnings record for at least one year before committing their funds. Apparently, experience has taught these firms a clear lesson. They must be able to recycle their money to get a satisfactory return on their capital; the time lag and the serious difficulties in getting their money out of new businesses has pushed their funds toward more mature companies.

The limitations that the SEC has developed on the secondary sale of securities are probably more damaging to small business financing than the high cost of registration and the near disappearance of the private offering exemption. Rule 144 has been successful in bringing clarity and certainty to the requirements for the resale of securities purchased without registration. Where Rule 144 is harmful is in its effort to protect the market from selling pressure through quantitative limitations on the shares which may be sold in any six-month period. This

quantitative limitation has a whole series of consequences that impede venture investing, are counterproductive to investor protection and promote concentration.

This restriction makes the shares of many small companies second-class property. The owner will frequently not be able to require or justify the cost of a registration. He will not even be able to use his shares as collateral. This taint will continue indefinitely until the shares are eventually "leaked" into secondary markets. The certainty that all this will severely discount the value of the restricted shares does not increase their appeal to sophisticated investors. Even when their intrinsic potential is enough to overcome these deterrents, the limitations on moving out of a risk investment cause venture capitalists to go in for smaller percentages and in lesser amounts. The restricted pace at which they are able to liquidate their investment contributes substantially to the trend to stay away from young companies and to confine venture capital investment to companies that have matured or seem to be on the verge of maturing. When they do have a successful investment, the difficulty of recycling their investment through private sales gives an edge to

the large company that can take over the new company in one bite. This, in turn, reduces competition and promotes concentration. Today it is moving our technology offshore to German and Japanese companies.

As long as there are restrictions on unusual compensation and other selling efforts, it is difficult to see why any quantitative limitation is required. The seller's interest in not driving down the price of the shares he wants to sell can be relied on for any protection the market needs.

It's disappointing that in the announcement of these hearings, it was indicated that the need to revise the Commission's Rule 144 is not to be considered at these public hearings. When Rule 144 was adopted over five years ago, it was, as I recall, stated to be an experiment to be continously evaluated and improved upon as the need and opportunity to do so became apparent. The quantitative limitations of Rule 144 were supported by no empirical data. The then existing restrictions were simply viewed as too severe and cut in half by applying the same quantitative limitation to a six-month period instead of an annual period. I have never heard that any significant investor protection was lost by that step.

It's been close to a year and a half since the then Chairman of the Commission announced an economic

study into the need for this quantitative limitation. I confess to some scepticism as to what an economic model will tell us that we do not know from simple observation -- that the market absorbs the presently established quantitative restrictions of regularly traded companies in a matter of days and weeks. While the study goes on, venture capital stays away from private placements in new and growing companies, and the need of many of these companies for expansion financing pushes them into a conglomerate or, as Senator Nelson recently pointed out, with a dozen or so examples, into foreign ownership. This is the kind of area in which the Commission has traditionally acted on the basis of a judgment balancing perceived hardship against theoretical damage. If the judgment turns out to be wrong, it can be reversed.

You know how a steadily increasing portion of the nation's savings is being accumulated in large institutions. Today, the amount of money which employee funds and other trusts and insurers must invest is so large that their managers do not have the time to place a million or two in an innovative business. This creates a need for professionally managed pools of venture capital which will bring to institutional funds and even private investors the special opportunities which high risk investment represent to some tastes and needs. No one

is likely to undertake to create and operate such a venture capital company if it is subject to the Investment Company Act. Some Small Business Investment Companies have gotten out of small business financing to become operating companies and others have refrained from raising additional capital from new stockholders because the requirements of the Investment Company Act, enacted for companies investing in the public securities markets, are so burdensome in financing new and growing private companies. When I came to the Commission a hearing examiner had recommended exempting SBIC's from the Investment Company Act, and two Commissioners had voted for the exemption. It seems to me that another look at this in the light of changing needs and circumstances is called for.

Whether protecting investors should be subordinated to other social and economic objectives such as the current need of small business enterprises is a threshhold question in your present inquiry. I agree with the Advisory Commisison on Corporate Disclosure that the protection of investors, through the disclosure to them of all material information necessary to an informed investment or corporate suffrage decision, should not be subordinated to other social and economic objectives, such as the encouragement of small business enterprises.

But there are degrees of protection. The very capable staff of the Commission cannot assure every bit of material information or all the protection that might be desirable. Registration is not the only way of providing information. Participants in private and local transactions can and must carry responsibility to demand material information. In Rule 10(b)5, the Commission has developed an instrument that, over the last year or so, has produced expanded disclosure in offerings of municipal securities, which are exempt from registration. Also, the Commission has developed its continuous disclosure system to a point where the investing public has or should have readily available both historical and current information on the performance of any company with over five-hundred shareholders and assets of one million dollars,or which wants to sell unregistered securities under Rule 144.

The securities laws have been a wonderfully flexible instrument, and it is to the great credit of those who have served on the Commission and its staff over the years that they have had the ingenuity to develop and apply them to a constantly changing investment environment, to new practices and methods in trading and investing and to new forms of skulldugery. But in this kind of adaptation of statutes and development of regulatory practice, it is inevitable that the process will occasionally overshoot its mark.

As an example, the statute never intended that an investor buying unregistered securities under an exemption would be treated as an underwriter or that the broker's exemption would be narrowed so that the Commission could, as it did in Rule 144, perpetually restrict and permanently discount the value of unregistered shares acquired under an exemption. In fact, when the Commission was offering "no action" letters after the two or three year holding period, I don't believe this resulted in any serious loss of investor protection at all comparable to the damage to small business financing which Rule 144 has inflicted.

The SEC has, like most other agencies of government, been slow to recognize and act on situations like this where the law has been developed or applied in a way which is counter-productive, or unnecessary, or distorts its original intention or all of these.

Improving the registration and reporting process is a continuous task and it is encouraging to see the possibilities in that direction being so thoroughly explored. But, in addition, we need to revise exemptions which will encourage venture capital, which I believe substantial investors have in abundance, to flow to unseasoned companies.

This is the way to direct unseasoned companies to the right kind of money. If the registration route is the only way to go, most unseasoned companies will be unable to afford it, and those who can will be pushed on too many hundred

dollar investors and that's the wrong kind of money. You have Rule 146 as an alternative but that's too complicated and costly for the kind of friends and neighbors who finance most of the new businesses in this country.

What is needed now is an act of will on the part of the Commission

- -- to recognize that public savings and attitudes have shifted direction in a way, which combined with some of the Commission's rules, have severely impaired our ability to generate and expand new business activity;
- -- to free entrepreneurs to get together with a limited number of backers without registration or potential liability, in the absence of fraud;
- -- to permit investors to resell interests acquired without registration after a few years as long as information has been made available through the Commission's continuous disclosure system (the Wheat report found this compatible with investor protection a decade ago); and
- -- to develop mechanisms to facilitate the operation of venture capital pools without requiring them to have their capital commitments screened in Washington.

In some of these areas the Commission can act on its own, such as exempting small business financing companies from

the Investment Company Act and freeing unregistered shares from Rule 144 after three years or five years. In other areas, it can, as it did with Rule 144, enhance investor protection by requiring improvements in its continuous disclosure system as a condition to the relaxation of rules which turn out to be unnecessarily restrictive. In other areas, legislation will be required. For example, the proper scope of the private offering exemption appears to have been so misconstrued in the courts, it will take legislation to restore the original congressional intent. The Commission has only to take the limited offering concept out of the securities code that Louis Loss and his colleagues in the American Law Institute have drafted, convert it into a legislative recommendation with whatever modifications your deliberations suggest as appropriate, and the respect the Commission commands in the Congress would almost certainly result in restoring a workable private offering exemption.

In conclusion, let me repeat the conviction that the Commission has before it an important opportunity to demonstrate that government can retrace its steps and relax its grip, and that this Commission and its staff does have the ingenuity to provide necessary investor protection without maintaining restrictions and requirements which inhibit the creation and expansion of enterprises which can provide jobs, reduce our trade deficit, strengthen our currency and produce goods to absorb inflationary pressures at home.

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