SBA
1977

REPORT
of the
SBA TASK FORCE
on
VENTURE AND EQUITY CAPITAL
for
SMALL BUSINESS

U.S. Small Business Administration

January 1977

FOREWORD

In July 1976, Mitchell P. Kobelinski, Administrator of the U.S. Small Business Administration (SBA), appointed a Task Force on Venture and Equity Capital for Small Business to assess the financing problems facing the small businessman today and to recommend solutions. The Task Force was made up of 15 people actively involved in managing, financing or advising small businesses. It is grateful for assistance provided by officials from the SBA, the SEC, the Treasury and Labor Departments, and private financial institutions.

The Task Force met several times as a full group and more frequently in smaller subcommittees. Early in the discussions it became apparent that the scope of the study had to go beyond just the provision of venture capital to very small businesses, because of the interrelated nature of all forms of capital required by business.

The Task Force believes the implementation of the study's recommendations can make a vital contribution to America's free enterprise system. If the recommendations included in the Report are favorably acted upon by the Administration and the Congress, it is the opinion of the Task Force that critically needed new venture and equity capital will flow to the small business sector of our economy, which in turn will produce substantial increases in jobs, tax revenues and productivity.

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SUMMARY OF SPECIFIC RECOMMENDATIONS MADE BY THE TASK FORCE

Tax Laws and Regulations

- - - Increase the corporate surtax exemption from the present level of $50,000 up to $100,000;
- - - Allow greater flexibility in depreciating the first $200,000 of assets;
- - - Permit investors in qualified small businesses to defer the tax on capital gains if the proceeds of the sale of a profitable small business investment are reinvested within a specified time in other qualified small business investments;
- - - Increase the deduction against ordinary income of capital losses in a small business investment made under Section 1244 of the Internal Revenue Code from $25,000 in annual deduction to $50,000, and increase the limit on an offering from $500,000 to $1,000,000 and on issuer size from $1,000,000 to $2,000,000 in equity capital;
- - - Permit underwriters of the securities of smaller businesses to deduct a loss reserve against the risks inherent in the underwriting and carrying of such securities;
- - - Revise methods by which revenue impact of tax changes are estimated to reflect revenue gains from the business use of tax savings and the stimulus to capital formation that tax incentives provide.

Small Business Administration (SBA)

- - - Provide that some portion of the guaranteed borrowing available to SBICs take the form of debt with the interest partially subsidized, if the funds are used to make equity investments;
- - - Permit SBICs a deduction from ordinary income for loss reserves on both the equity and debt portions of their portfolios;
- - - Immediately make a substantial increase in the size standards for SBIC investments and also provide for either an annual revision of these standards or index them according to broadly accepted price indicators;

- - - SBA should require and encourage commercial banks to assume a larger portion of the risk in SBA loans and change its guarantee fee from a one-time fee of 1% of the amount of the guaranteed debt to an annual fee which more nearly reflects the value and cost of SBA's guarantee;
- - - Substantially expand SBA's Secondary Market Program by creation of a "Certificate" system for the sale of SBA-guaranteed loans.

Institutional Investors/Employee Retirement Income Security Act (ERISA)

- - - Amend ERISA to declare a policy that pension funds may invest in a broad spectrum of American companies within the "prudent man" rule and that it applies to the total portfolio rather than any individual investment. Also create a "basket" of 5% of the assets of any plan within which investment managers can invest according to standards of prudence and liquidity appropriate to higher risk small business investments;
- - - The development of professionally managed pools of capital should be encouraged so that pension fund managers, otherwise constrained by time or expertise, may participate in the investment in new ventures and in growing smaller companies. These special funds should be specifically exempted from the provisions of the Investment Company Act of 1940;
- - - In cooperation with the SEC and other regulatory bodies, exempt the illiquid securities of small companies from "mark-to market" or " fair value" accounting treatment.

Securities Laws and Regulations (SEC)

- - - Increase the small offering exemption from $500,00 to $3,000,000;
- - - Enact the limited offering exemption as proposed in the American Law Institute project to codify the securities laws;
- - - Retain and simplify Rule 146;
- - - Amend Rule 144 to provide that the existing quantitative limits apply for only a three-month period rather than a six-month period. In addition, change those limits to one percent of outstanding shares or the average weekly volume, whichever is higher instead of whichever is lower;
- - - Develop procedures under which solicitation, with appropriate compensation to develop a market, may be undertaken if buyers are provided with copies of financial data and other disclosures regularly filed with the SEC along with a suplemental statement on mode of offering, identity of underwriters, price of securities offered, and information needed to update the data on file with the SEC.

INTRODUCTION

Small businesses comprise 97 percent of all unincorporated and incorporated businesses in the United States. More than half of all business receipts are generated by their operations. Perhaps more important, they employ more than half the U.S. business work force.

It is a matter of acute concern that, in the face of clearly emerging needs and the documented benefits to the United States economy, a set of impediments have developed that are preventing smaller businesses from attracting the capital without which they cannot perform their traditional function of infusing innovation and new competition into the economy. Unless these impediments are overcome, the ability of the economy to compete in the world and meet the needs of the American public will be seriously eroded.

It is alarming that venture and expansion capital for new and growing small businesses has become almost invisible in America today. In 1972 there were 418 underwritings for companies with a net worth of less than $5,000,000. In 1975 there were four such underwritings. The 1972 offerings raised $918 million. The 1975 offerings brought in $16 million. Over that same period of time, smaller offerings under the Securities and Exchange Commission's (SEC's) Regulation A fell from $256 million to $49 million and many of them were unsuccessful. While this catastrophic decline was occurring, new money raised for all corporations in the public security markets increased almost 50 percent from $28 billion to over $41 billion.

A public policy that discourages the public from investing approximately $1 billion a year of its savings in economic innovation, growth, and the creation of jobs while it encourages the public to risk $17 billion a year in Government-sponsored lotteries, requires close and serious reexamination.

Impediments to Small Business Growth

In this context, the Task Force sees in the American business and financial scene today the following characteristics:

1. A public policy that tilts sharply towards encouraging consumption and discouraging savings and investment.

2. An increasing and dangerously high ratio of debt to equity arising in part from artificial tax advantages extended to debt financing.

3. Distinct impediments to raising equity and other forms of risk capital.

4. Savings gravitating towards larger institutions that are discouraged from investing those savings in smaller and new businesses.

5. Well-intentioned efforts to protect investors which inadvertently place small businesses at a disadvantage in competing for available funds.

6. Attrition and concentration in the network of financial institutions and firms that has served our economic needs well by mobilizing capital.

A recent study by the Massachusetts Institute of Technology Development Foundation has arresting data on the importance of new companies and new technologies to property and jobs in America. It compares the performance of six mature companies, five innovative companies, and five young high-technology companies. From 1969 to 1974, the average annual contributions of these companies in jobs and revenues shaped up as follows:

Type of Companies	Sales Growth	Job Growth
Mature	11.4%	0.6%
Innovative	13.2%	4.3%
Young High Technology	42.5%	40.7%

Although these young companies are not only growing faster but actually creating more new jobs and tax revenues than the giants of American industry, we see increasing impediments to this same opportunity for other new companies.

Recent economic trends have caused all investors -- institutional, large nonfinancial companies, venture capitalists, individuals and local bankers -- to become more conservative in their investment policy. Recent legislation and regulation, however well intentioned, has added to that conservatism by cutting incentives to take risks. Savings and other financial resources, so desperately needed by small companies to finance their growth, have become concentrated in larger financial institutions. For example:

- - - Since 1962, deposits in the ten largest banks have increased from 20 to 33 percent of all deposits.

- - - Pension funds assets have tripled since 1962 and it is estimated that by 1985 more than half of all equity capital will be in the hands of pension fund managers.

- - - Mutual funds assets have doubled in the same time period.

- - - Institutions now account for 70 percent of the volume of trading on the New York Stock Exchange (NYSE).

As assets have concentrated, access to them has become more difficult, particularly for small businesses. In the past 5 years, the number of registered securities broker/dealer firms has declined 35 percent, and the number of registered representatives has declined as well. The Task Force has found that this shrinkage of the securities industry has compounded the problem of providing smaller companies with access to capital. Large institutional investors handling pension funds, wary of standards set forth in the 1974 Employee Retirement Income Security Act (ERISA), are concentrating their funds in larger companies with proven earnings records to avoid possible lawsuits and liabilities under ERISA.

Individual investors, once a vital source of funds for new businesses and liquidity for early investors, have been so hurt in recent bear markets that they are reluctant or unable to provide risk funds again. In addition, the incentive for individuals to risk capital in equities has been drastically reduced by a capital gains tax rate that today can run from 70 to 100 percent more than the maximum rate that prevailed as recently as 1970.

Compliance with Government regulations -- tax returns, registration statements, ERISA reporting requirements, and a great variety of reports and surveys -- constitutes a heavy burden for the small businessman. Although highly commendable efforts to lighten this load are under way, the small business today is in grave danger of smothering under the weight -- and cost -- of repetitive paperwork.

One of the more serious problems is t he skyrocketing cost of entering the public market to seek new sources of financing. An analysis of six of the smaller offerings made in 1976 by companies having assets of less than $5 million shows the average cost of registration is $122, 350, an automatic and, in some cases, insurmountable roadblock for companies interested in entering the public market.

The Life Cycle of Growing Businesses and Its Financing

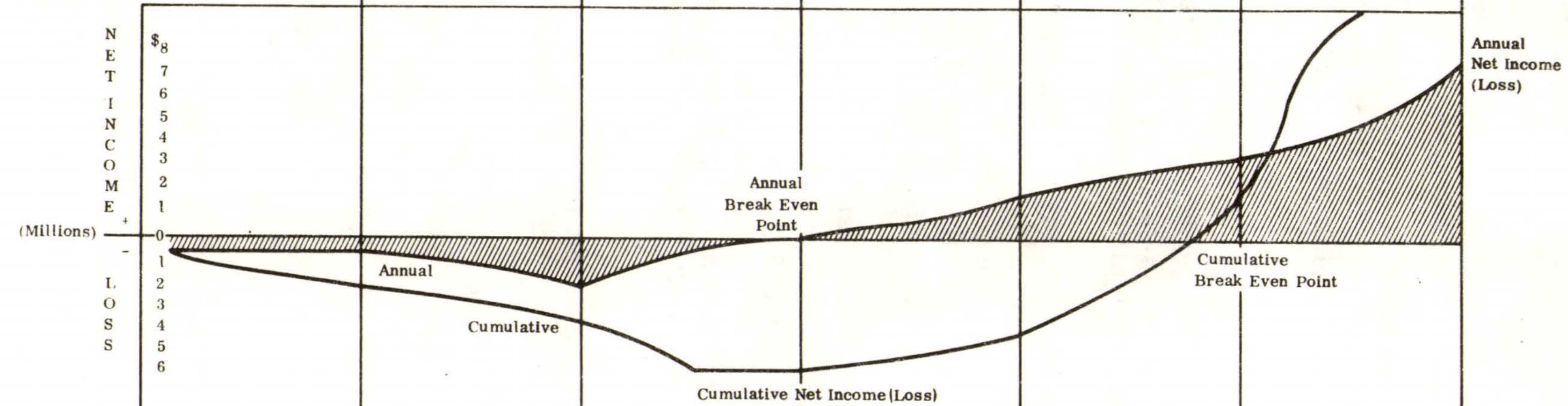
The result of all these trends has been to make economic growth for smaller companies increasingly difficult. The chart on the next page illustrates the stages a company must go through to achieve maturity as a corporate entity.

The cycle of a business enterprise requires different types of capital at each stage of its life. The highly developed U. S. marketplace has spawned investors for each of these many stages. The result can be imagined as a financial pipeline along which successful companies move from start-up to maturity.

If this pipeline flows smoothly, all types of investment capital can function. If it clogs at any point, capital dries up all along the pipeline. Facilitating the turnover of initial investments to more conservative investors is critical to unblocking the flow of initial higher risk investments in smaller businesses. In fact, the Task Force believes that creating better prospects of liquidity for early investors will, in itself,

LIFE CYCLE OF A NEW ENTERPRISE
MODEL OF A GROWING AND SUCCESSFUL COMPANY
1975-1976 FINANCIAL MARKET CONDITIONS

Phase: / Activity Level: / Revenues in Millions	0	1	2	3	4	5
Activity Level	R&D	Start-Up	Early Growth	Accelerating Growth	Sustaining Growth	Maturity
Revenues in Millions	-None-	Up to $2.0	$2 - 10	$10-25	$25-40	$40 and up



I Company Characteristics:	0	1	2	3	4	5
Capitalization	$5,000-1,000,000	$500,000-2,500,000	$2 million - 6 million	$6 million - 15,000	$15 million - 30 million	$30 million +
Length of Phase (Years)	1-5	1-3	2-3	3-4	2-5	-
Management and Organization	Founder; No Organization	Founder & Associates; Very loose organization	Founder or Professional Manager; Emerging Formal Organization	Founder or Professional Manager; Formal Organization	Professional Managers; Complex Organization	Multi-layered Complex Management Organization
"Equity" Financings Number	2-3	1-3	2-3	1	1-2	Ongoing
Average Size (Nature)	$100,000 (private)	$750,000 (private)	$1,500,000 (private)	$7,500,000 (public or senior private)	$15,000,000 (Insurance Co. and other long-term capital).	(Various)

II Applicable Govt. Regulations
- Tax Rate
- Depreciation Allowance
- Sub-Chapter "S"
- IRS: Rule 1244
- SEC: Rule 144
- SEC: Rule 146
- Regulation "A"
- SEC: 1933 Act

III Principal Financing Sources

Private
- Personal Investment
- Individual Investment
- Investment Firms (SBIC's etc.)
- Commercial Bank - Personal
- Commercial Bank - Corporate
- Insurance Companies

Public Financing

restore the flow of equity investment in the early stages of business life. Hence the Task Force focused on institutional investors and the public stock market, in addition to other sources of risk capital, internal financing and long-term debt financing.

Traditionally, businesses have used a mixture of internal and external financing for their needs. Small businesses cannot grow very fast if they have to finance themselves solely out of their earnings. In most cases external sources must provide the financing for significant growth.

As shown on the chart, however, a hypothetical company moving through the system must reach a revenue level of up to $10 million before public financing becomes even remotely possible. Moreover, it is not until a business reaches revenues of $25 to $40 million that all sources of public and private funding become, in some measure, available.

Though Government agencies provide a great deal of assistance to small businesses through agencies such as the Small Business Administration (SBA), there are legislative limitations on this agency's programs that prevent them from being completely responsive to the small businessman's needs for equity capital. Because private financial resources are at times unavailable, the small businessman is often faced either with stagnation or the sale of all or part of his company.

In addressing the financial needs of small businesses and the impediments to meeting them, it soon becomes apparent that the problem is different for:

a. the many small businesses that are local in character or so family owned and managed that they would be unlikely to have or want access to the public securities markets; and

b. those businesses that can develop so that they will need access to public financing.

There are different remedies called for with respect to these two broad categories of smaller businesses.

There is a cycle of financial events and opportunities into which new and growing businesses have to fit themselves to finance their growth and expansion. This cycle starts off with the ability to save and the will to commit those savings in order to start a small business. Here, if public policy is to reflect the contribution new and small business can make to the national welfare, our tax system has to encourage necessary savings and the commitment of these savings to new and small businesses.

Then, after a new business is launched, the tax system should permit it to generate sufficient internal capital so that a growing equity and credit base will enable it to meet growth requirements. This can be done with some deferral of tax payments; allowing small businesses greater flexibility in charging off the assets needed to do its business; and an increase to reflect inflation in the amounts to which small business tax treatment now applies. This will provide greater revenues for the Government in the future as small businesses use this increase in internal financing to provide additional jobs and greater taxable wages and profits.

From among the new and small businesses that grow as a result of these tax revisions, a few will show a potential for generating jobs and profits that are sufficient to attract funds from private, public and institutional investors. These businesses should be able to compete for these funds on equal terms with older, larger and more established businesses. Savings will not be invested in these new and growing enterprises unless the investors can efficiently convert their investment to cash over time without undue penalty. The seed money needs of these innovative and growth-oriented businesses used to be met by knowledgeable investors found in towns and cities all over America. In the last fifteen years, a significant portion of this activity has become institutionalized and professionalized in enterprises having risk money together with experience and skill in identifying unusual business opportunities in technological developments and emerging needs.

Today however, surveys of the investing activity of leading professional venture capitalists, having total assets estimated at $1.7 billion and investing in excess of $100 million per year in venture capital situations, show an increasing proportion of their funds going to established companies. In 1975 only five percent of new investments went to start-ups of new ventures and two percent to first-round financings.

This represents a sharp reduction from previous years. Most venture capital firms have adopted a policy of staying away from start-ups and have put their available capital in safer and more liquid investments. The Task Force believes this steady shift towards a more conservative investment policy comes from perceived difficulty in recycling investment funds as restrictions on the access of small and growing business to the public securities markets has become more costly and difficult.

COMPANIES WITHOUT ACCESS TO PUBLIC SECURITIES MARKETS

The very small business, usually local in character, is likely to be launched on the personal savings of family and friends by an entrepreneur interested in full ownership and attracted to the prospects of financial reward.

His primary financial advisor will usually be his local banker, who provides advice, counsel and, more importantly, short-term credit for his generally undercapitalized enterprise. Local bankers are likely to go as far as conventional economic wisdom and prudent banking standards permit in granting loans on the basis of confidence and character. Certainly the banker cannot be adequately compensated for making this type of loan because of the risk and servicing involved. He, and the entrepreneur, are taking calculated risks, hoping for greater rewards -- increased deposits and profits -- in the future.

With these loans and private resources, the entrepreneur begins his business with a reasonable relationship between debt and equity capital. If the business prospers, he approaches his banker for funds to purchase additional inventory or to handle his multiplying accounts receivable. He continually borrows short term, being fully convinced that he will have funds to repay within the 30-day term of the loan. The banker, pleased with this progress, continues to advance funds, all in short-term notes renewed and rewritten at regular intervals. This satisfies the bank's need to adjust loan interest rates quickly and to show liquidity on its books.

As this small business grows, however, the availability of this type of financing fades away as its dangers emerge. Short-term indebtedness goes up and retained earnings are unable to grow as fast as the business. Paradoxically, the more profitable the business is, the worse its financial statement looks because of the high ratio of debt to equity.

As internal financing becomes increasingly difficult, the entrepreneur's external source of financing, his banker, may begin to run into loan limit problems. Moreover, as more and more local banks are absorbed by large banks, the entrepreneur may find himself faced with a more impersonal and cautious branch manager, who may not want these small business risks.

The entrepreneur begins to realize the value of long-term financing. He turns to the government for help, in most cases to the SBA. He finds that this agency's programs of direct and guaranteed loans, and equity financing through SBA-licensed Small Business Investment Companies (SBICs), may be able to provide necessary assistance. Yet this assistance, too, has its limits.

Tax Revisions to Facilitate Internal Financing and Attract Capital

The fact is that for those businesses not likely to require or want to raise money from the public, capital growth needs must come from a combination of internal cash flow and from borrowing. To make it possible for many thousands of small businesses to realize their potential in growth and jobs, reform in the tax structure is essential.

The most direct and effective step that can help small business is to bring the \$50,000 of corporation earnings now taxed at a lower rate in line with inflation and the escalation of risks and higher costs in starting and carrying on business. Consequently, the Task Force recommends the corporate tax rates be modified so that the first \$100,000 of corporate taxable income should be taxed at lower rates, as follows:

First \$50,000	- 20 percent
Second \$50,000	- 22 percent
Excess over \$100,000	- 48 percent

Allowing these small businesses to use a larger portion of their first \$100,000 of earnings to grow will produce additional revenue and jobs. The Government will benefit from additional taxes and a reduction in welfare and other unemployment costs in the future.

Allowing small businesses greater flexibility in writing off the first \$200,000 of depreciable assets is another step that should be taken to increase the internal financing that is so critical to businesses in their early years.

The higher capital gains tax rate has altered the risk-reward relationship for investors. This is likely to have its greatest impact on equity investment in small businesses where capital is already scarce and the risk of loss is greatest. This was recognized by Congress in 1958 with the enactment of Section 1244 of the Internal Revenue Code that allows limited deduction of loss in a small business investment against ordinary income. To reflect inflation and increased capital costs in new businesses, the limitations surrounding this provision should be increased so that deduction of \$50,000 instead of \$25,000 is permitted a taxpayer in any one year. The limit on issuer equity capital and size of the financing necessary to qualify should be increased respectively from \$1,000,000 to \$2,000,000 and from \$500,000 to \$1,000,000.

The capital gains tax has become so high that it no longer serves as an incentive to provide long-term investment capital. Deferring that tax as long as these funds remain invested in small business can provide a major incentive to attract the individual investor back to investing in small companies. The Task Force recommends that investors in qualified small businesses should be permitted to defer the tax on capital gains if the proceeds of a profitable sale are reinvested in another qualified small business within a specified time period. There is ample precedent for this kind of deferral in home sales, condemnations and retirement plan distributions. Since small businesses are potentially the most rapidly growing part of the equity investment spectrum, the ultimate tax revenues can be significantly higher, more than offsetting the cost of deferring revenues.

These tax revisions will result in a reduction of some tax revenue and deferral of other revenue. The Task Force takes issue with the method currently used in the Treasury's forecasts of the revenue impact of tax legislation. These revenue estimates reflect only the reduction in tax collections from tax revisions without any offsetting allowance for income which will result from retaining and using the revenue reductions in business activity. Nor does it reflect the stimulus to capital formation and economic activity which greater incentives will provide. The Task Force believes that a more accurate and balanced method of evaluating the impact of proposed changes is essential to developing sounder tax policy. It recommends that, at the earliest possible date, the new Secretary of the Treasury review the methods now used to forecast the revenue loss from tax changes.

SBA Assistance in Long-Term Borrowing

The tax revisions discussed above will allow small companies to generate more substantial cash flows internally and, thus, attract greater financing from their banks. Beyond that, if small businesses are to be restored to their full role in contributing to national economic growth and generating jobs, the financing role of SBA should be strengthened. Therefore, the Task Force believes it important that SBA programs be put on a more self-sustaining and flexible basis.

The SBA is to be commended for steadily shifting its emphasis from direct loans to the guarantee of bank financing. In this way SBA has increasingly utilized the more intimate knowledge of local businesses and local economic risks and opportunities and the greater ability to supervise loans which local banks almost invariably have. At the same time it has provided small businesses with long-term financing that local banks, subject as they are to the requirements of regulatory agencies to keep their assets liquid and maturities short, have not been able to provide.

The SBA is also to be commended for helping local banks to bring institutional funds into small business financing by instituting its Secondary Market Program. Under this program, banks making SBA-guaranteed loans can now sell them to other investors to improve the banks' liquidity and bring new funds into local financing by offering Government-guaranteed, good yield investments to institutional and other investors. Since the program's inception through September 1976, more than $406 million of these loans have been sold to investors who would find it difficult to lend directly to small businesses. This successful Secondary Markets Program should be substantially expanded. The SBA-proposed "Certificate" system would transform the guaranteed portions of SBA loans into freely transferable market securities. This would tap additional institutional investor sources of capital, remove bankers' reservations about liquidity and reduce bank examiners' concerns over long-term loans in banks' portfolios. In order to ensure full utilization of these new resources, a comprehensive public information program aimed at small businessmen should be instituted.

The Task Force believes that SBA can strengthen its ability to contribute to the financing needs of small business by placing its operations on a more business-like basis in two very important respects:

1. Requiring and encouraging commercial banks to assume a larger share of the risk in the long-term financing that SBA facilitates through its guarantee. For example, the SBA might require banks to retain 15% instead of 10% of the risk in these loans and use a sliding guarantee fee to induce banks to take an even larger portion of the risk.

2. In extending a seven-year guarantee for a one-time fee of one percent SBA is not being adequately compensated. Additionally, there is little or no incentive for either the borrower or the lender to do without the guarantee. A basic guarantee fee of one-half to one percent a year would still be a bargain to most small businesses. An increase in the fee would also place some limitation on the demand for SBA's guarantee and more adequately offset the losses SBA sustains in extending its guarantee.

The Task Force recognizes that these steps will increase the cost of SBA financing. However, the availability of financing is more important than such a modest increase in cost. These steps will bring SBA activities closer to a self-sustaining basis. This should encourage the Congress and the Office of Management and Budget to increase the SBA guaranty authority as small businesses and local banks show a readiness to share more of the risk and pay a more realistic price for SBA-assisted financing.

Strengthening the Small Business Investment Company (SBIC)

SBICs are an important source of long-term debt financing and equity and venture capital for small business.

Although SBICs provide a significant amount of pure equity financing, there has been a tendency for them to increase their holdings in loans and other debt instruments of small businesses. The major incentive for the creation and operation of SBICs is the availability of long-term Government-guaranteed loans that require very modest equity and provide attractive investment leverage to those supplying equity capital for an SBIC.

This leverage has from time to time been increased by law. To meet the interest cost of these increased borrowings, SBIC investments have tended heavily toward interest bearing debt securities, rather than common stock. This has a tendency to add to the debt burdens of the smaller business rather than providing the permanent capital that this size of business so badly needs.

To resolve this problem, the Task Force recommends that some portion of the Government loans providing SBIC leverage be available in the form of debt, on which interest is partially subsidized. This would relieve the pressure on SBICs cash flow and enable them to make more pure equity investments.

Another disincentive for SBICs to take risk is the tax treatment of loss reserves. Currently, SBICs may establish a loss reserve for only those investments which are in the form of debt securities. The Task Force recommends that SBICs be authorized to deduct loss reserves from ordinary income on both the equity and debt portions of their portfolios in order to encourage more equity investments.

SBA has partially adjusted for inflation by increasing its size standards for SBIC investments. However, these adjustments tend to lag behind the realities of the marketplace. Therefore, the Task Force recommends that SBA adjust its size standards for SBICs annually or that these standards be measured against broadly accepted price indexes.

COMPANIES SEEKING PUBLIC CAPITAL

Small businessmen whose enterprises survive and thrive may find it necessary to seek external financing from investors having more substantial and varied capital resources than commercial banks and the SBA. There is a new set of obstacles on this road to economic growth.

The access of small companies to public markets, particularly in the early 1950's, encouraged the formation of venture capital -- money that was available for innovation and small business growth in the hope that some of the funds invested could be recovered within two to five years.

Venture capitalists, however, like all investors, found that the years following 1969 were difficult ones. They were forced to cut back on investments in many new ventures, because without a lively secondary market for resale of these securities, underwritings do not take place. Without underwritings, there are no investments, and the economy suffers. The table below illustrates the precipitate decline in offerings and money raised for companies having net worth of $5 million or less.

Year	No. of Offerings	Total Dollar Amount (in millions)
1969	548	$1,457.7
1970	209	383.7
1971	224	551.5
1972	418	918.2
1973	69	137.5
1974	8	13.1
1975	4	16.2

The first stages of market recovery in 1975-1976 have not been strong enough to rebuild confidence, particularly that of individual investors, in the new issues market.

Making Institutional Funds More Available to Small Business

Institutionalization of the stock market has meant that the small businessman must appeal to a professional investor who has a large amount of money and limited time to analyze potential investments. Increasingly, a major source of capital in America is the money in pension and other employee trusts. Fiduciary standards created by ERISA, however, have isolated about $200 billion of money in these trusts from all investments other than large blue chip, and fixed income securities. Attorneys advising trust officers have interpreted ERISA regulations conservatively, although they do not differ significantly from commonly practiced standards of fiduciary responsibility. As a result, trustees are reluctant to invest in companies without strong earnings records. Most pension trustees find it neither economic or prudent to invest in companies without a capitalization large enough to give investors liquidity. It appears that the market value of a firm must be over one hundred million dollars to interest pension funds managers.

ERISA should be amended in two important respects:

1. To expressly declare a policy of allowing pension funds to invest in a broad spectrum of American companies by clarifying ERISA's "prudent man" standard so that it is clearly applicable to the total portfolio of pension fund investments rather than individual investments, and

2. To relieve pension fund managers of ERISA restrictions in investing up to five percent of pension fund assets in companies having less than $25 million in net worth and larger companies having limited marketability for their securities.

These modifications should be designed to encourage the development of professionally managed pools of capital to assume responsibility for segments of the portfolio that pension fund managers do not have the time or experience to effectively invest in new ventures and growing companies. The SEC should exempt these special funds from the time-consuming and cumbersome requirements of the Investment Company Act of 1940.

The current interpretation of Financial Accounting Standard Boards regulations has led to substantial short-term profit and loss impact on portfolios. These standards require portfolio managers to value these holdings of unregistered securities and report the resulting portfolio changes as profit or loss, even though no transactions take place. These fluctuations in both valuation and profit and loss are arbitrary and time consuming. Requiring "fair value" accounting creates the onerous task of frequently evaluating the current fair value of investments in small company securities. Most institutions avoid this by simply staying with only large, marketable equity securities or high quality debt securities. It would be consistent with the principle of materiality to waive the requirement for fair value accounting for investments made within the five percent "basket" provision we have recommended.

Small Business Access to the Public Securities Markets

The small businessman will find more and more securities firms disappearing with changes that have taken place in brokerage economics. Fixed commission rates have been eliminated and rates are governed by competitive and free market forces. Principal beneficiaries of this change have been institutional investors, not individual investors.

All these forces have substantially dried up access to the securities markets for small businesses. There are fewer regional securities firms, fewer registered representatives, fewer trading desks and research facilities.

Today, most underwriting is by the "majors", and these "majors" will not generally underwrite companies with annual earnings of less than $2 million. The few remaining strong regional brokers are working almost exclusively with firms whose earnings are between $1 million and $2 million.

To keep small firms with growth potential from being shut out of the public securities market the SEC created Regulation A (based on the small offering exemption in the Securities Act of 1933). This facilitates securities offerings of $500,000 and less by exempting them from the costly and time-consuming undertaking of full registration. This is not much capital for a growing company in the light of today's needs and the value of today's dollar. The Task Force commends SEC Chairman Roderick Hills for recommending that the Regulation A exemption be extended to offerings up to $2 million. However, it is impressed by the need for the underwriting of most Regulation A offerings as shown by the SEC's finding that, during the period 1972 to 1974, in 546 Regulation A filings only 35% of the shares offered were actually sold. Since few firms in the contracted securities industry will underwrite an issue of less than $3,000,0000 today and firms which do handle small issues are anxious to take advantage of the savings in time and cost which Regulation A makes available, the Task Force believes the limit should be increased to $3 million.

Congress also provided a private offering exemption in enacting the Securities Act of 1933. Administrative and court interpretations have so narrowed the scope of this exemption that investors in very small financings have been able to change their minds and get their money back simply because the offering had not been registered. The buyer of stock who is defrauded has been provided with an effective remedy by the SEC through its development of Rule 10b(5). Requiring a small business to register a limited financing under pain of having to return the proceeds in the absence of any fraud was never intended and Congress should take legislative action to restore the private offering exemption.

The SEC developed Rule 146 to provide a safe harbor for private offerings that claim the private offering exemption and do not register. The SEC is to be commended for an imaginative effort to clear up the difficulties created by the attrition of the statutory private offering exemption. However, this Rule will necessarily be cumbersome, complicated and burdensome until Congress acts to restore the original intent of the private offering exemption. Meanwhile, there are modifications in Rule 146 which can be helpful and the Task Force recommends Rule 146 be modified in two respects:

1. In the "information to be provided" provision insert the words "if material" to modify the information required in the offering circular; and

2. Add a provision, along the lines of that provided in Rule 240, that failure to furnish information or an inability to sustain the burden of proof with respect to other offerees will not permit a buyer who has been properly informed to demand recision.

The limitations that the SEC has developed on the secondary sale of securities are probably more damaging to small business financing in the public securities markets than the high cost of registration and the near disappearance of the private offering exemption. If the kind of risk money that goes into new and growing businesses cannot be readily recycled it is usually not invested. It is the inability to readily convert some of the profits on successful investments back into cash that has driven professional venture capitalists away from start-ups towards companies with proven earning records. Furthermore, this leads to the liquidation of investments through large corporate takeovers instead of by sales in the public securities markets.

Congress, in enacting the Securities Act of 1933, required registration of securities only of issuers, underwriters and dealers. Anyone else was to be free to sell without registration. Until the late sixties, it was generally considered that holding a security for two years established that it had not been purchased for resale as an underwriter and could be sold without registration. During the late sixties and early seventies, considerable uncertainty developed about restrictions on resale of securities and in 1972, the SEC issued Rule 144.

Rule 144 has been successful in bringing clarity and certainty to the requirements for the resale of securities purchased without registration. However, it has, in the view of the Task Force, created unnecessary and unjustified restrictions on the private resale of unregistered shares which contribute substantially to clogging the flow of capital to smaller businesses.

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. 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 restrict venture capital to companies which 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 smaller company in one bite. This, in turn, reduces competition and promotes concentration.

Moreover, as long as there are restrictions on 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 to limit the shares he offers. Certainly there is no evidence to justify a limitation which extends for six months and there is ample evidence that the present maximum is usually absorbed in a matter of weeks or days, when there is any real market at all.

The Task Force therefore recommends that as a first step Rule 144 be amended so that existing quantitative limitations apply for only a three-month period instead of six months and that the limit be set at one percent of outstanding shares or the average weekly volume over a four-week period, whichever is higher instead of whichever is lower.

The Task Force is pleased to learn that SEC Chairman Hills has initiated an economic analysis to reevaluate the need and justification for a quantitative limit on resales of securities that have not been registered. It hopes that the quantitative limit will be eliminated or enlarged further if economic analysis shows that there is little or no justification for it.

The Task Force also recognizes that many small businesses do not enjoy an active market for their shares. Rule 144's prohibition against solicitation requires that there be a reasonably active market in a security if substantial amounts are to be sold. Thus, reduction or removal of the limit on shares offered will be only marginally beneficial to investors in many small businesses because of the limitations on solicitation coupled with a relatively thin market.

The Task Force therefore hopes that the SEC, and the experienced and knowledgeable Disclosure Committee it has designated under the chairmanship of A. A. Sommers, develop procedures under which solicitation and compensation required to develop a market will be permitted. The Task Force believes that active selling should be permitted when buyers are provided with copies of the financial data and other disclosures regularly filed with the Commission and a supplemental statement on the mode of offering, the identity of any brokers involved, the prices at which the securities are to be offered and any information necessary to update the data on file with the Commission.

Acquisitions and Concentration

The Federal Trade Commission's 1976 report on mergers and acquisitions states:

> "As in the previous three years, acquired firms that fell into the smallest asset size class accounted for the highest proportion of recorded acquisitions. Acquisitions of firms in the under $1.0 million and unknown asset size class represented 935, or 76.1 percent of the total number of recorded completed and pending acquisitions. For many of the acquired companies in this category, asset figures were unavailable -- most likely because the acquired company was quite small. The $1.0 - $9.9 million asset size class had the second highest proportion of acquired companies (11.5 percent)."

As we have already developed, limitations on the ability of private investors in successful small businesses to sell their shares to other investors have resulted in large companies being able to entirely buy out successful small companies at a discounted price because the business and its individual owners have little alternative in meeting their financing and liquidity needs. This is, we believe, the major force increasing concentration and big corporation bureaucracy and diminishing competition in the American economy today.

We recognize that mergers are a legitimate means of developing liquidity. Frequently, a growing business needs the capital and management expertise of a larger partner for continued growth. On the other hand, many mergers in the past five years have been "shotgun weddings" because of an environment that offered the small businessman no alternative methods of acquiring capital and liquidity.

Recently, larger companies have begun selling and restructuring peripheral portions of their operations as smaller, free-standing businesses. Freer availability of risk capital to encourage divestitures of this kind can revitalize these smaller operations and provide new, challenging opportunities for both technological and personal advancement. It can also inject new forces of competition which will benefit all who participate in our economy as consumers, producers and investors.

RECOMMENDATIONS FOR FUTURE ACTION

The recommendations of this Task Force offer only partial solutions to the problems of equity and venture capital for small businesses. No solutions remain adequate for very long. Problems multiply as society becomes more complex. There is a need to deal with small businesses problems on an ongoing basis. But there are no marble palaces in Washington for small business nor are there many champions whose voices are heeded. A Task Force such as this can only provide a snapshot of the conditions which its individual members experience and observe. It should submit its report, make its recommendations, and then go out of existence. Small businesses, however, need strong ongoing advocacy aimed at creating the optimum environment for their growth. It is the considered view of the Task Force that this role should be lodged in the Office of the Administrator of the SBA.

The SBA is a small, independent Federal agency, and SBA Administrators until very recently did not sit as a member of the various advisory bodies Presidents have used in coordinating economic policies. Yet this agency could be the principal voice of half of the nation's business community. The Task Force believes the SBA Administrator should be charged with an active role on behalf of small business in a number of areas:

- The SBA should expand its role as a catalyst and advocate within the government for changes reflecting the concerns of small businesses. These concerns are fragmented among many agencies and action on them often appears at random, too little or too late. The SBA should not only act to coordinate the Federal Government's activities relating to small business, but also to serve as an intermediary between various government units and private groups representing small businesses and their sources of financing.

- The planning and research activities of the SBA should be strengthened and its area of interest extended beyond its SBIC and 7(a) Bank Loan Guaranty program to include the general health of the public and venture capital market as well. These studies should be directed to such specific matters as the competitive impact of option trading on market trading in shares of smaller companies and its effect -- if any -- on the new issue market in these shares.

As a final note, the Task Force believes the government can play a vital role in stimulating the creation of new products that can be produced and marketed by small business. Too often an invention developed with government support has become the government's invention and not the inventors. Also too often, worthwhile technology developed by the government for special purposes such as defense or space has not been commercially developed. SBA's interest in this area could stimulate the economy, and result in increased jobs and tax revenues.

If small businesses are to continue as a vital force in today's economy, their interest and requirements must be considered and advocated vigorously. The Task Force believes that the steps outlined here can significantly increase the contributions which these enterprises can make to the U.S. economy.

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