

**MEMO# 3635**

March 25, 1992

# **SEC REGULATORY AND LEGISLATIVE PROPOSALS CONCERNING SMALL BUSINESS INITIATIVES**

March 25, 1992 TO: BOARD OF GOVERNORS NO. 20-92 SEC RULES COMMITTEE NO. 15-92  
RE: SEC REGULATORY AND LEGISLATIVE PROPOSALS CONCERNING SMALL BUSINESS INITIATIVES

The Securities Exchange Commission has developed a package of legislative and regulatory proposals designed to promote capital formation of small businesses. The significant aspects of these proposals are outlined below.

I. Legislative Proposals The SEC has submitted to Congress a legislative proposal entitled the "Small Business Incentive Act of 1992." The proposal recommends the following amendments to the Investment Company Act of 1940 and the Securities Act of 1933.

A. Investment Company Act

1. Section 3(c)(7) - The bill would create a new "qualified purchaser" exception from regulation under the 1940 Act for investment pools whose securities are held by certain highly sophisticated investors. The SEC would be given rulemaking authority to define who constitutes a "qualified purchaser." The SEC's memorandum in support of the proposed legislation states that it anticipates that, "at least initially, the definition of 'qualified institutional buyer' in Rule 144A under the Securities Act of 1933 [i.e., certain institutional investors that own or invest on a discretionary basis at least \$100 million in securities] would represent an appropriate standard for determining the level of sophistication for those institutions investing in proposed section 3(c)(7) issuers." The memorandum also states that it would be appropriate to allow natural persons that possess a high degree of sophistication to invest in the new Section 3(c)(7) pools.

2. Section 3(c)(1) - Section 3(c)(1) of the Act, the private investment company exception, currently includes a two-part attribution rule designed to prevent circumvention of the 100 investor limit included in that provision. The attribution rules provide that beneficial ownership by a company is deemed to be ownership by one person, except that if such company owns 10% or more of the outstanding voting securities of the issuer, the issuer must "look through" to the underlying investors. However, the second part of the test states that it may not be necessary. The Commission believes that the current attribution test is unnecessarily broad. The proposed legislation would amend Section 3(c)(1) by exempting all entities other than investment companies from the "look through" provisions for purposes of applying the 100 investor limit under Section 3(c)(1).

3. Section 12(d)(1) - The bill would amend Section 12(d)(1) so that the limitations thereunder would no longer apply to the purchase of private investment company securities by registered investment companies. Therefore, the limit on investment company purchases of securities of Section 3(c)(1) issuers would be raised from 3% to 10% (which is the limit imposed under Section 3(c)(1), as discussed above). The current Section 12(d)(1) limitations would still apply to the purchase of registered investment company shares by Section 3(c)(1) companies.

4.

Section 6(a)(5)(A) - The bill would create a statutory exemption for companies (a) that are not engaged in the business of issuing redeemable securities, (b) the operations of which are subject to the business and industrial development laws of the state in which it is organized, (c) of which not less than 80% of its securities being offered are held by persons who reside or have a substantial business presence in that state, (4) the securities of which are offered solely to accredited investors, as defined in Section 2(15) of the Securities Act, and (5) that do not purchase any securities issued by investment companies, except in certain limited instances set forth in the proposal.

5. Section 6(d)(1) - The bill would amend Section 6(d)(1), which provides an exemption for certain small intrastate closed-end funds, by increasing the aggregate amount of proceeds that may be raised by such funds from \$100,000 to \$10 million or such other amount as the Commission may set by rule or order.

6. Business Development Companies - The bill would amend certain provisions applicable to business development companies ("BDCs"), which are closed-end funds that are permitted to invest only in certain specified types of securities and are exempt from several of the provisions of the Investment Company Act. Currently, a BDC must have at least 70% of its assets in certain specified securities. In satisfying the 70% test, BDCs are expected to acquire primarily securities of "eligible portfolio companies." In general, an eligible portfolio company must fall into one of three categories: (a) entities which do not have any class of securities with respect to which credit may be extended pursuant to the margin rules of the Federal Reserve Board, (b) certain companies which are controlled by the BDC, and (c) companies which meet such other criteria as the SEC may establish by rule. In addition, BDCs are permitted to purchase other specified securities, cash items and government securities in satisfying the 70% test. An important element included in the definition of a BDC is that it is required to "make available significant managerial assistance" with respect to the companies that are treated by it as satisfying the 70% test described above. The bill would amend the following provisions relating to BDCs.

a. Section 2(a)(46) - The bill would expand the definition of "eligible portfolio company", to allow BDCs to invest in companies which do not have total assets in excess of \$4 million and capital and surplus in excess of \$2 million.

b. Section 2(a)(48) - The bill would amend Section 2(a)(48) to provide that a BDC is not required to make available significant managerial assistance to any company that falls within the new definition of "eligible portfolio company" described above.

c. Section 55 - The bill would amend Section 55 to clarify that a BDC's investment in the new "eligible portfolio company" securities described above would count toward the 70% of its assets that must be invested in certain specified securities. In addition, Section 55 would be amended to permit a BDC to acquire the securities of an eligible portfolio company from persons other than the eligible portfolio company or its affiliated persons, subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

d. Sections 61(a)(2) and (a)(3) - The bill would amend Sections 61(a)(2) and (a)(3) to remove various restrictions on the capital structures of BDCs.

B. Securities Act 1. Section 3(b) - The bill would increase the offering limitation for exempted securities under Section 3(b) from \$5 million to \$10 million.

II. Regulatory Proposals and Changes

A. Investment Company Act 1. Limit on Illiquid Assets - The SEC revised the Guidelines to Form N-1A to increase the amount of illiquid assets that a mutual fund may purchase from 10% to 15%. This change became effective on March 20. (See Memorandum to SEC Rules Members No. 13-92, dated March 23, 1992.)

B. Securities Act 1. Regulation E - The SEC proposed amendments to Regulation E, which exempts from registration under the Securities Act certain offerings by small business investment companies ("SBICs") registered under the Investment Company Act and by BDCs, to increase the aggregate offering price of securities of SBICs that may be sold during a twelve month period from \$5 million to \$15 million. The aggregate offering price of securities issued by a BDC that is not a SBIC would remain unchanged. The amount of SBIC

or BDC securities that may be sold annually by any person other than the issuer would increase from \$100,000 to \$1,500,000. 2. Regulation A - The proposal would amend Regulation A, which permits the unregistered public offering of securities under specified conditions, to increase the dollar amount on such offerings from \$1.5 million to \$5 million. In addition, issuers would be allowed to solicit indications of interest prior to filing an offering statement with the SEC (i.e., "test the waters"). 3. Regulation D - The proposal would amend Rule 504 of Regulation D, which exempts from registration annual offerings of up to \$1 million by non-Exchange Act reporting issuers, to permit securities issued under Rule 504 to be freely traded without registration and without the conditions regarding state registration currently imposed by that Rule and to remove limitations on the issuer's ability to engage in advertising or other general offering activities. 4. Disclosure Requirements - New disclosure requirements are proposed for "small business issuers", as defined in the amendments to Rule 405 under the Securities Act and Rule 12b-2 under the Exchange Act, which would be used for both Securities Act registration and Exchange Act proxy and reporting requirements. III. Status of Legislative Proposals The Senate Banking Securities Subcommittee is scheduled to hold a hearing on the SEC's proposals on March 26. The Institute plans to submit a written statement to the Subcommittee by April 2. Therefore, please provide me with any comments you have on the legislative proposals by March 30, 1992. A copy of the SEC's legislative proposals and related documents are attached as Attachment A. IV. Comment Periods for Regulatory Proposals A. Regulation E - Comments on the proposed amendments to regulation E are due by May 19. Please provide me with your comments on this proposal by April 30. A copy of the SEC's release proposing amendments to Regulation E under the Securities Act is attached as Attachment B. B. Regulations A and D - The comment period for these proposed amendments expires on June 18. Please provide me with any comments you may have on the proposed amendments by May 22. A copy of the summary of the amendments to Regulations A and D under the Securities Act is attached as Attachment C. If you would like a copy of the entire release, please contact the undersigned. \* \* \* We will keep you informed of developments relating to the SEC's small business initiatives. Amy B.R. Lancellotta Associate General Counsel Attachment