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Notes

The Regulation by the Investment Company Act of 1940 of Small Business Investment Companies Established Under the Small Business Investment Act

In recent years, a difficult problem has emerged involving the question of whether Small Business Investment Companies formed under the Small Business Investment Company Act of 1958 should be subject to the regulatory provisions of the Investment Company Act of 1940. The solution to this problem necessarily requires an understanding of (1) the purpose of the two acts and (2) the historical setting in which each was enacted. The author of this Note has therefore first discussed this background material and thereafter proceeded to analyze specific problem areas encountered by Small Business Investment Companies who attempt to comply with the regulatory provisions of the Investment Company Act of 1940. He concludes that only by giving the Small Business Investment Division complete responsibility for the regulation of Small Business Investment Companies will the latter be effectively controlled and promoted.

INTRODUCTION

As early as the 1930's, it became apparent that the growth and, indeed, the very existence of small business was threatened by the unavailability of long term loans and equity financing.1 This "investment gap"2 in the economy was due in large part to the fact

2. The term "investment gap" has been used to designate the gap in our economy's long term financial mechanism whereby little long term capital flows into small business. See H.R. REP. No. 2060, 85th Cong., 2d Sess. 5 (1958).
that no financial institution existed which was capable of furnishing adequate financial aid to small business. Although many individual investors concentrated their investments in this area, they were not able to furnish the large quantities of capital required by small business which a large institution would be able to supply.

In an attempt to remedy this situation, Congress in 1958 passed the Small Business Investment Act (SBIA). The SBIA sought to encourage the formation of small business investment companies (SBICs) whose primary function was to furnish long term loans and equity financing to small business concerns.

3. See ibid.; McCallum, The Small Business Investment Act of 1958—Its First Year of Operation, 45 Va. L. Rev. 1039 (1959). For example, commercial banks were unable to fulfill this financial need because their main function was to provide short term and intermediate term capital. See S. Rep. No. 1652, 85th Cong., 2d Sess. 2 (1958). Also, Small Business Administration loans were limited to ten years with a possible ten year extension which did not satisfy small business long term needs. Ibid. Furthermore, the use of a public issue by a small business was usually impossible because of its cost and the fact that it was difficult for a small business to gain public acceptance of its securities. See McCallum, supra. Studies by the SEC indicate that the cost of having a public stock issue is all but prohibitive when the amount of the issue is less than $1,000,000. Comment, 25 Brooklyn L. Rev. 39, 40 (1958).

4. One reason that institutional sources of equity and long term loans failed to develop was that many investors were not willing to assume the risk usually inherent in small business loans. Normally, small businesses have limited access to physical resources and to markets for their goods. Also, their management and production knowhow is usually more limited than is the case with larger businesses. As a result, loans to a small business are risky because their use of investment funds may be much less efficient and productive than larger businesses. However, federal surveys and reports have indicated that even small businesses with good credit risks found it almost impossible to obtain adequate equity and long term loans. Murphy & Netter, The Small Business Investment Act of 1958, 19 Fed. B.J. 162, 164 (1959). The inability of these small businesses to obtain financing was due in large part to the lack of a motivating force to channel the flow of funds into deserving small businesses. See S. Rep. No. 1652, supra note 3, at 3, 5. Congress sought to supply this motivating force through SBICs formed under the SBIA.


The policy and purposes of the SBIA are clearly stated in the following excerpt from the act:

It is declared to be the policy of the Congress . . . to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply . . . .


6. See 72 Stat. 689, 15 U.S.C. § 661 (1958). The term "small business concern" is defined by the regulations of the Small Business Investment Division as follows: "Small business concern" means one which is independ-
Many SBICs organized under the SBIA come within the regulatory provisions of the Investment Company Act of 1940 (the 1940 act). The purpose of the 1940 act was to protect the funds of investors in investment companies from misuse by the managers of these companies. However, many businessmen—especially those interested in the organization and promotion of SBICs—assert that SBICs should be exempt from the 1940 act. Their contention is that the SBIC and the type of investment company sought to be regulated by Congress through the 1940 act differ so greatly in purpose and operation that the former cannot be promoted or regulated effectively by the 1940 act.

The purpose of this Note is to discuss the desirability and feasibility of exempting SBICs from the 1940 act. Two introductory sections will present a background for this discussion. The first section will deal with the provisions and operation of the SBIC and the second will consider the application of certain regulatory provisions of the 1940 act to the SBIC.

I. THE PROVISIONS AND OPERATION OF THE SMALL BUSINESS INVESTMENT ACT

A. THE ESTABLISHMENT, CAPITAL STRUCTURE, AND OPERATION OF THE SBIC

The SBIA established the Small Business Investment Division (SBID) of the Small Business Administration for the purpose of licensing and regulating SBICs. An SBIC may be formed by a minimum of ten persons who must first submit a "proposal" evidently owned . . . and not dominant in its field of operation." 13 C.F.R. § 107.103-1 (1959). See ibid. for a further definition of the term.

The most important reasons that investment companies desire to be licensed are (1) licensed companies can obtain funds from the SBA and,(2) tax advantages are afforded to both licensed companies and their investors. See notes 22–27 infra and accompanying text and note 99 infra for a further discussion of these advantages.

2. See S. REP. No. 1775, 76th Cong., 3d Sess. 6–8 (1940); H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940).
4. Ibid.
to the SBID which requests permission to proceed with the formation of a company.\textsuperscript{14} The SBID is given discretionary power to determine whether it should grant permission to proceed.\textsuperscript{15} In exercising its discretion, the SBID is to be guided by the following test: will the SBIC make a sound contribution to small business financing?\textsuperscript{16} The proposed SBIC must incorporate under state law and may conduct only those activities prescribed for such entities by the SBIA.\textsuperscript{17} If permission to proceed is granted, the proposed SBIC is entitled to apply for a license to operate under the SBIA.\textsuperscript{18} After the SBIC has complied with any conditions set forth in the SBID's approval letter and has filed the additional information required by the license application, the SBIC may be licensed.\textsuperscript{19} The SBIC is usually formed for a period of 30 years

\footnotesize
\begin{enumerate}
\item The "proposal" must contain such information as the SBIC's proposed policies, operation plans, and capital structure. See 13 C.F.R. § 107.201-2(b) (1959) for a complete list of the contents of such a proposal.
\item In exercising that discretion some of the factors the SBA must consider are: (1) the need for small business financing in the area in which the proposed SBIC is to operate; (2) the general character of the management of the proposed SBIC; (3) the number of similar companies already formed in the United States; and (4) the business volume of such companies. ibid.
\item The act gave the SBID authority to charter SBICs until June 30, 1961 if it found a company could not be chartered under the laws of a particular state. 72 Stat. 691, 15 U.S.C. § 681(a) (1958). After that date, all SBICs must be chartered under state law. Murphy & Netter, supra note 4, at 167.
\item However, it seems clear that an SBIC would have little trouble incorporating under Minnesota law. Minnesota corporation law states specifically that a corporation, when it is so provided in its articles of incorporation, may acquire, hold, or dispose of the shares, bonds or other evidences of indebtedness of any domestic or foreign corporation. MINN. STAT. § 301.10 (1957). Presumably under this section, an SBIC could be formed for the purpose of financing small business corporations. However, it is not clear from this section that an SBIC could lawfully finance unincorporated small businesses. On the other hand, another provision of the Minnesota corporation laws states that a corporation may be formed for any lawful purpose. MINN. STAT. § 301.03 (1957). Hence, an SBIC could probably finance unincorporated small businesses.
\item See 13 C.F.R. § 107.201-2(i) (1) (1959). The SBID may also reject the proposal or give notice to the interested parties to furnish further information establishing that approval is warranted. 13 C.F.R. § 107.201-2(i) (2) (1959).
\item 13 C.F.R. § 107.201-3(c) (1959). The licensed SBIC has powers similar to other corporations; these include the power to contract, to sue, and to be sued. See 72 Stat. 691, 15 U.S.C. § 681(d) (1958) for a complete list of the powers possessed by the licensed SBIC.
\end{enumerate}
with the right to extend for another 30 years if two-thirds of its shareholders approve.\footnote{20}

The financial structure of an SBIC consists of two levels. First, there is the equity level which includes paid-in capital and surplus. Before receiving an SBID license, a proposed SBIC must submit evidence to the SBID that it has paid-in capital and surplus of at least $300,000.\footnote{21} The SBIA authorizes the Small Business Administration to furnish $150,000 of this capital to each licensed SBIC by the purchase of its debentures.\footnote{22} These debentures must be subordinated to other debenture bonds, to promissory notes, and to other obligations issued by the SBIC.\footnote{23} The availability of this source of capital is a great aid to the beginning SBIC because it is not forced to rely solely on funds from private investors. However, the regulations of the SBID make it clear that the Small Business Administration may furnish capital funds only to the extent that such funds are not available to the SBIC from private sources.\footnote{24}

The debt level is a second means by which SBICs can gain investment resources by issuing debenture bonds, promissory notes, and other obligations under such conditions and limitations as the SBID shall provide.\footnote{25} Debt financing enables those in control of organizations interested in attracting industry to their area and helping existing industry to expand. Profit motive is of secondary importance for these SBICs.\footnote{20} A great many of these companies are state and local development companies which may qualify under the SBIA.

A second type is the SBIC formed as a concomitant to an existing business activity or to aid in the development of a specific industry. An example of this type is the bank which organizes an SBIC to gain more flexibility in its operations and to be able to furnish more services to its customers. For example, an SBIC would be able to furnish equity capital to small business—an activity which the bank itself cannot undertake.

A third type—which is probably most important from the standpoint of amount of aid furnished to small business—is organized primarily to furnish venture capital to small business offering promising growth potential. High potential profits together with desirable income tax consequences for high income taxpayers are the two principal attractions to possible investors in this type of SBIC. See McCallum, supra note 3, at 1042–43; Murphy & Netter, supra note 4, at 163–64.

\footnote{23} Ibid.
\footnote{24} See 13 C.F.R. § 107.302 1(c) (1959). See id. at § 107.303–2(a).

The SBID also has authority to limit the holdings of any individual, group, or class in a particular SBIC. 72 Stat. 692, 15 U.S.C. § 682(c) (1958).

the SBIC to obtain additional funds without losing control because such securities are non-voting. In addition, this method of financing increases the earning potential of equity securities because debt securities do not share in the SBIC's earnings above their fixed rate of return. Thus, the benefit of income from debt funds in excess of their fixed rate of return is realized solely by the equity security holders. However, SBID regulations limit the use of debt financing by providing that the ratio of an SBIC's outstanding indebtedness to paid-in capital and surplus shall not exceed four to one.26 Furthermore, the Small Business Administration is authorized to lend money to an SBIC by purchasing its debt securities to the extent of 50 per cent of the particular SBIC's capital and paid-in surplus.27

B. THE PROCESS BY WHICH SBICs FINANCE SMALL BUSINESSES

In fulfilling its primary function, the SBIC provides private equity capital and long term loans to small business concerns for the purpose of promoting their general business operation, growth, and modernization. Long term loans may be made to incorporated or unincorporated small businesses for a term of 20 years with the possibility of having the loan extended for an additional ten years.28 The maximum rate of interest on such loans is determined by the SBID.29 Within this framework the terms of the long term loan agreement are left to negotiation between the SBIC and the small business interested in obtaining funds. The SBIA provides that equity financing may be furnished "in such manner and under such terms as the small business investment company

29. Ibid. The SBID regulations provide that the maximum rate of interest on an SBIC loan to a small business shall not exceed the maximum rate applicable to such a loan under local law. If no maximum rate exists under local law, the maximum rate chargeable by an SBIC shall be set forth in its proposal for review by the SBID. See 13 C.F.R. § 107.305-1(e) (1959). At the present time, SBID regulations prohibit the cost of funds loaned to small businesses from an SBIC to exceed 15%. This cost not only includes interest but also such expenses as investigation fees which are charged to the borrowing small business. S. REP. No. 1293, 86th Cong., 2d Sess. 20 (1960).
may fix in accordance with the regulations of the administration."\(^{20}\)

The applicable SBID regulations provide that the terms and conditions of furnishing equity are left to negotiation between the SBIC and the small business involved unless these terms represent major variances from the investment policies stated in the SBIC's proposal.\(^{31}\) If such a variance exists, the resulting agreement is subject to the approval of the SBID.\(^{32}\) The SBID regulations governing equity financing benefit both the SBIC and small business because they allow sufficient flexibility; that is, the individual needs of the small business may be considered. As a result, SBICs are able to perform their function of stimulating small business activity.

C. THE FUNCTION OF THE SBID

The primary function of the SBID is to regulate SBICs.\(^{33}\) The scope of its supervision is divided into two general areas. First, SBID regulations govern the organization and operation of the SBIC. For example, as noted earlier, the SBID has authority to license the SBIC,\(^{34}\) to approve or disapprove its articles of incorporation,\(^{35}\) and to provide conditions and limitations on its authority to lend money.\(^{36}\) In addition, the SBIC must obtain the approval of the SBID before it can invest more than 20 per cent of its capital and surplus in any single enterprise.\(^{37}\) By this type of regulation, the SBID seeks to insure that the SBIC will effectively carry out the purposes of the SBIA. Second, certain SBID regulations are designed to protect the interests of SBIC investors. To illustrate, the SBID, by regulation, prohibits those in control from


Before any capital is provided to a small business, the SBIC may require a refinancing so that it holds the small business' total indebtedness. The SBIC can also require that the small business give it first option to finance any additional indebtedness. 74 Stat. 196 (1960), 15 U.S.C. § 684(b) (Supp. II, 1961).

Prior to this amendment, convertible debentures were the only means by which SBICs could furnish equity to a small business concern. 72 Stat. 693 15 U.S.C. § 684(b) (1958). See generally U.S. CODE CONG. & AD. NEWS 223 (1960) for a discussion of the reasons for the amendment.


\(^{32}\) Ibid.


\(^{34}\) See note 11 supra and accompanying text.

\(^{35}\) See note 17 supra and accompanying text.

\(^{36}\) See note 31 supra and accompanying text.

dealing with themselves to the prejudice of other shareholders.\textsuperscript{38} The exercise of such regulatory power promotes SBIC development because persons are more likely to invest in a company whose operations are subject to the control of a governmental agency.

In order to discover violations of SBID regulations and of SBIA provisions, the SBID is empowered to examine each SBIC and to require such reports as shall be necessary to facilitate its power of examination.\textsuperscript{39} When in the judgment of the SBID a company has violated or is about to violate the SBIA or a regulation issued thereunder, the SBID may seek an injunction in any United States District Court.\textsuperscript{40} In addition, the SBIC which violates such a provision or regulation may lose its license to operate under the SBIA.\textsuperscript{41} However, before an SBIC loses its license, the company must be adjudged guilty of the alleged violation by a United States Court.\textsuperscript{42}

II. PROVISIONS OF THE 1940 ACT SIGNIFICANT FOR SBICS

A. THE EXTENT TO WHICH SBICS ARE REGULATED BY THE 1940 ACT

The 1940 act defines the term "investment company" as an organization formed for the purpose of investing, trading, or holding securities.\textsuperscript{43} Any company which falls within this definition and is not registered under the 1940 act is prohibited from selling its own securities or purchasing the securities of another person by means of the mails or any other instrumentality of interstate commerce.\textsuperscript{44} An unregistered investment company is also prohibited from engaging in any business in interstate commerce or controlling any company which carries on business in interstate commerce.\textsuperscript{45}

\textsuperscript{38} 13 C.F.R. § 107.306-1(b) (1959). See notes 133-36 infra and accompanying text for a discussion of other investor protections provided by SBID regulations.
\textsuperscript{42} Ibid.
\textsuperscript{43} 
Other investment companies may register under the 1940 act, but they are not required to do so as long as their activities are confined to *intrastate* commerce. Since SBICs primarily invest in and hold small business securities, they come within the 1940 act's definition of an investment company. Thus, the SBIC is within the regulatory power of the 1940 act unless the particular company confines its activities to intrastate commerce. However, it would seem that the practical effects of not being able to use the mails or other instrumentalities of interstate commerce would encourage most SBICs to register under the 1940 act. Otherwise, the company's business operations would probably be curtailed or at least impeded.

The 1940 act, however, does provide specific exemptions for certain investment companies which otherwise would fall within its regulatory power. One such exemption—which is clearly applicable to the SBIC—provides that any investment company whose securities are beneficially owned by not more than 100 persons and which does not have, or presently contemplate making, a public issue is exempt from the 1940 act. Therefore, an SBIC may be initially outside the regulatory power of the 1940 act and subject only to the provisions of the SBIA. But if the SBIC later increases its total shareholders to more than 100 because of growth or a public issue, it will then come under the regulation of both the 1940 act and the SBIA.

**B. SPECIFIC ABUSES CONCERNING INVESTMENT COMPANIES WHICH THE 1940 ACT SOUGHT TO PREVENT**

The investment company as it existed prior to 1940 represented a means by which amounts of capital could be gathered from many small investors so as to obtain the benefits of large scale expert investment. On many occasions a small group of individuals with little personal investment gained control of the in-

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47. See 54 Stat. 797 (1940), 15 U.S.C. §§ 80a-3(b)-(c) (1958) for a list of the types of companies exempt from the 1940 act.
49. A potential problem area under this exemption is that of determining when an SBIC has presently proposed a public issue. The SEC, which is charged with administering the 1940 act, could expand its scope of control considerably by liberally construing this phrase.
50. See Note, 41 COLUM. L. REV. 269 (1941).
vestment company and used its resources for their own benefit rather than that of the investment company's shareholders. The 1940 act was passed primarily to prevent this abusive use of power by those in control of investment companies. These abuses can be divided into four categories.

I. Failure to Provide Adequate Information Concerning the Investment Company's Activities

First of all, many investment companies failed to provide adequate, accurate, and specific information concerning their business policies and investments to their shareholders and prospective investors. Shareholders often had no effective voice in developing the investment company's business policies because they were unable to discover what its existing policies were or what policy changes were contemplated by those in control. Also, prospective investors could easily be misled as to the policies and condition of the investment company because of inadequate disclosure. To remedy this abuse the 1940 act required all registered investment companies to file a registration statement with the SEC. This statement, which is open for public inspection, must state the business policies to be followed by the investment company and must also list the names, addresses, and business experience of the company's management. Investment companies must also submit semi-annual reports to their shareholders showing the

51. S. REP. No. 1775, supra note 8, at 6–7.
See Tolins, The Investment Company Act of 1940, 26 CORNELL L.Q. 77, 84–85 (1940) for a discussion of the various ways by which such a small group of individuals could gain control of the investment company.

52. In the opinion of the committee, the Security and Exchange Commission, and the industry itself, the legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managers and to provide such investors with a regulated institution for the investment of their savings. This legislation will also prevent those abuses which have damaged the reputation of the industry as a whole.
H.R. REP. No. 2639, supra note 8, at 10.

53. The act explicitly states that its policy is to eliminate this abuse.

54. In many cases the lines of communication between the investment company and its shareholders were so badly blocked that the shareholders were unable to determine who actually controlled the company. See Note, 88 U. PA. L. REV. 584, 590–91 (1940).


financial condition and policies of the company.58 These reporting requirements are implemented by the provisions which make it a criminal offense to submit willingly any untrue, misleading, or misrepresentative statements in any reports required by the 1940 act.69

2. Improper Portfolio Management

Another abuse common to investment companies was portfolio management in the interest of those in control rather than the shareholders.60 For example, a favorite quick profit activity of investment company managers was to issue new stock to themselves below the net asset value61 of the company’s other stock. The new stock would then be sold on the open market62 or redeemed by the company at the net asset value resulting in a quick profit for the managers.63 To prevent this mismanagement, the issuance of securities below net asset value of the company’s other shares is prohibited by the 1940 act.64 Another example of improper portfolio management involved the purchase of stock from

58. 54 Stat. 836–37 (1940), 15 U.S.C. § 80a–29(d) (1958). The 1940 act lists various types of reports and authorizes the SEC to designate which of these the investment companies must submit to its shareholders. Some of the statements listed are a balance sheet, a list showing the amounts and values of securities owned, an income statement, and a statement of surplus. Ibid.

In addition, the source of any dividend payment must be disclosed to stockholders. See 54 Stat. 821 (1940), 15 U.S.C. § 80a–19 (1958). This prevents a company from paying dividends to shareholders to convey the impression that there have been substantial earnings when actually these dividends have been paid out of the company’s assets.


61. The “net asset value” of a share of stock is the total value of the company’s assets less its liabilities divided by the total number of the company’s outstanding shares. See S. Rep. No. 1293, supra note 29, at 21, which raises the problem of how an SBIC values its securities when calculating the net asset value of its stock.

62. The market value of a share of stock is usually close to that stock’s net asset value. Therefore, if a stock is issued below its net asset value the issue price is probably also below the stock’s market value. As a result, the sale of such stock on the open market usually results in a quick net profit to the seller.

63. See Motley, Jackson & Barnard, Federal Regulation of Investment Companies Since 1940, 63 Harv. L. Rev. 1134, 1144–46 (1950), for a discussion of the prevalent abuses resulting from the issuance of securities below net asset value of other shares.

those in control of the investment company. It was common for persons—especially brokers and investment advisors—to gain control of a company by means of proxies and voting trusts and then use the company as an unloading block for their own worthless securities. The 1940 act sought to prevent such mismanagement by regulating the use of proxies and voting trusts and by requiring that all stock issued must be voting stock. Also, the self-dealing aspects of this abuse were dealt with by prohibiting companies from purchasing securities from brokers, dealers, or other persons affiliated with the investment company.

3. Abuses Involving Investment Company Accounting Practices

A third major abuse prevalent among investment companies was the use of unsound, misleading, and unsupervised accounting practices. One problem in this area arose from the fact that the


Additional provisions of the 1940 act attempting to prevent self-dealing provide that at least a majority of a company’s management cannot also be the company’s regular brokers or investment advisors. 54 Stat. 806 (1940), 15 U.S.C. § 80a–10(b) (1958). Section 10(d) of the 1940 act makes certain exceptions to § 10(b). In addition § 10(c) provides that a majority of the board of directors cannot be directors of a single bank. Section 10(e) lays out the procedure for filling vacancies on the board to prevent the board of directors from becoming self-perpetuating. To further ensure that a company’s directors are free from a divided or conflicting interest the 1940 act provides that only 60% of the company’s directors can be investment advisors or their affiliates, officers or directors of the investment company. 54 Stat. 806 (1940), 15 U.S.C. § 80(a) (1958). However, self-dealing is most effectively prevented by the provisions which require that all directors be elected by a majority of voting shares, 54 Stat. 813 (1940), 15 U.S.C. § 80a–16(a) (1958), and that the employment contracts of advisors and managers be controlled by the directors and shareholders. 54 Stat. 812 (1940), 15 U.S.C. § 80a–15(a) (1958).

Senior security holders also found themselves being victimized by investment companies which sold large amounts of senior securities but failed to protect the rights of these holders. Thus, the 1940 act prohibited a company from issuing senior securities unless specific asset coverages of these securities existed. 54 Stat. 817 (1940), 15 U.S.C. § 80a–18(a) (1958). The asset coverage requirements of the 1940 act provide such holders with a measure of security to insure their payment at the proper time. The act also provided that senior security holders should elect a majority of the company’s board of directors if a dividend default occurred for two consecutive years and that no dividends should be issued unless a specified asset coverage of these securities existed. Ibid.

various investment companies did not follow uniform accounting procedures. As a result investors found it difficult to compare effectively, (1) the accounting reports of a particular investment company, or (2) the reports of one company, with those of another unless they were thoroughly familiar with the accounting procedures of the companies involved. Moreover, accounting methods could be adopted which would mislead the public as to the company's financial condition. For example, a company's accounting procedures could be changed by the company's management when it thought that its financial position could thereby be presented more favorably. Thus, in many cases only those persons most intimately connected with the company knew its actual financial status. To correct this situation, the 1940 act empowered the SEC to compel investment companies to keep such records and accounts as the SEC should deem necessary. The SEC may also issue regulations prescribing the accounting policies and principles to be followed in order to insure a reasonable degree of uniformity among investment companies. Shareholders are assured of having ultimate control over the company's accounting policies by the 1940 act's requirement that the investment company's controller or principal accounting officer must be chosen by its board of directors or shareholders and not merely by its executives.

4. Abuses Involved in Changing the Business Policy of the Investment Company

A further abuse was the practice by some investment companies of changing their business policies without the consent of their

70. Ibid.

Investors are often persuaded to invest in a company because of its reputation for making certain types of investments. Many times these companies would abruptly change their investment policy and, thus, the investor who relied on the company's previous investment policies held an unwanted investment. Such an abrupt change in the type of securities held by an investment company could be accomplished easily because most companies held extremely liquid securities. The investment policy change often caused the market value of the company's stock to decline. As a result, the investor who desired to sell his unwanted stock was forced to take a loss. The 1940 act attempted to ameliorate this situation by requiring that a company's classification and business policy be set forth in its registration statement at the time of organization. Prospective investors are thereby able to determine accurately what type of investment policies a particular company proposes to follow. In addition, the 1940 act provides that the business policy set forth in this classification can be changed only by a majority vote of all shareholders.

C. THE FUNCTION OF THE SEC UNDER THE 1940 ACT

The powers and duties of the SEC under the 1940 act fall into three general categories. First, the SEC is given broad authority to issue regulations which interpret specific sections of the act. The SEC also has power to exempt any investment company from its regulations and the 1940 act if the commission feels that the interest of investors will continue to be protected. Second, the SEC has the duty to collect all reports and records which the act requires investment companies to file. Finally, enforcement of the 1940 act is vested in the SEC. In order to facilitate enforce-

74. See Note, The Investment Act of 1940, 50 YALE L.J. 440, 444–46 (1941) for a discussion of the injurious results of such changes.
75. See S. REP. No. 1775, supra note 60, at 7. The electronics and aircraft industries are good examples of the type of investment which today would attract investors. The rapid advances made in these two industries and the resulting favorable publicity have made them very attractive to investors.
76. Ibid.
77. Ibid.
78. The 1940 act divides investment companies into three main classifications and various sub-classifications in order to provide special regulations for each type of investment company. See 54 Stat. 799 (1940), 15 U.S.C. §§ 80a–4–5 (1958). Thus, by knowing a particular company's classification it is possible to determine many of its business characteristics and policies.
ment, the commission has extensive powers to carry on investigations of possible violations of the act. If the commission believes that a violation is being, or will shortly be, committed, it is empowered to seek an injunction against the offending party in any United States District Court. The SEC may also transmit any evidence it has concerning such a violation to the United States Attorney General who may, in his discretion, institute criminal proceedings against the offender.

III. ANALYSIS OF THE APPLICATION OF THE 1940 ACT TO SBICs

At first glance it seems clear that if SBICs are investment companies they should properly come within the regulation of the 1940 act. In fact, the legislative history of the SBIA clearly indicates that Congress intended the 1940 act to apply to SBICs. However, a great many well-informed observers feel that SBICs should not be regulated by the 1940 act. Their position is not that SBICs should be unregulated but rather that the 1940 act is not the proper means for such regulation.

A. GENERAL POLICY GROUNDS FOR EXEMPTING SBICs FROM THE REGULATION OF THE 1940 ACT

The regulatory provisions of the 1940 act were directed particularly at the mutual fund type investment company which was

86. Ibid.
87. For example, the Report of the Senate Committee on Banking and Currency on the SBIA states:

The bill also provides that with one exception, the Investment Company Act of 1940 shall apply to small business investment companies just as it does at present to other investment companies. The committee was impressed by the testimony offered by the Chairmen of the SEC, that, in order to give adequate protection to investors, the Investment Company Act of 1940 should be applicable to small business investment companies.

S. REP. No. 1652, 85th Cong., 2d Sess. 13 (1958). Moreover, no amendment to the 1940 act specifically exempts SBICs from the act's regulation although such exemptions have been extended to banks, insurance companies, and underwriters. See 54 Stat. 798, 800 (1940), 15 U.S.C. §§ 80a-3(c), 80a-6 (1958) for a complete list of these exemptions.

88. See, e.g., the statement of Lee Davis, President, Tennessee Investors, Inc., Nashville, Tenn., in Hearings, supra note 56, at 209.
89. See statement of Elliot Davis, President of the Alliance Business Investment Co., Tulsa, Oklahoma. Id. at 161.
90. "Mutual fund investment company" as used in this Note designates the type of investment company prevalent at the time the 1940 act was
prevailed in 1940. As a result, it has been contended that SBICs should be exempt from the 1940 act since they differ so completely from the mutual fund type investment company. In fact, Wendell B. Barnes, former administrator of the Small Business Administration, has asserted that the question of the applicability of the 1940 act to SBICs would never have arisen had they not been called "investment companies."

Upon examination it becomes clear that substantial differences do exist between the SBIC and the mutual fund company. For example, the mutual fund company was formed so that small investors might pool their funds and thereby gain the advantages of diversified investments and expert portfolio management. These companies traditionally invest in the conservative marketable securities of large corporations. Thus, such companies are able to satisfy the small investor who, because of his limited resources, desires safe investments with a uniform rate of return. On the other hand, SBICs are formed primarily to aid small businesses by furnishing these concerns with venture and expansion capital through the purchase of their securities. These securities are typically unlisted. In addition, they are not readily marketable because they represent investments in small business and often are extremely speculative and risky. Thus, the primary purposes and the investment policies of each of these companies are substantially different. A second major difference between these two types of investment companies is in the type of investor they attract. The mutual fund type company tends to attract the inexperienced investor who because of his lack of investment knowledge desires passed and includes both open and closed end companies. These companies were organized primarily so that small investors could pool their resources for investment purposes. As a result, these investors are able to obtain the benefits of large scale investing and expert management. See notes 94 and 95 infra and accompanying text for a further discussion of the characteristics of this type investment company.

92. Id. at 231.
93. Id. at 114. In addition Stephen A. Calder, Vice President, National Association of Small Business Investment Companies, states that members of his association who have discussed the matter with SEC officials report that they base their jurisdiction over SBICs on the fact that they are called "investment companies." Id. at 163.
95. See Hearings, supra note 91, at 308.
96. See id. at 195.
97. Ibid.
to place his funds in the hands of an expert manager. In contrast, the speculative nature of SBIC investments tends to attract the knowledgeable investor with large resources who seeks the speculative but potentially large profits and the tax advantages afforded the SBIC investor. In addition, the SBIC and mutual fund company differ in their methods of investing funds. The SBIC deals personally with the individual small business in negotiating financial arrangements whereas the mutual fund company makes its investments by purchasing securities of publicly held corporations on the open market. Although the differences between the two types of investment companies are substantial, it would be inaccurate to say that it is impossible for the 1940 act to regulate both types of companies effectively. However, these differences should arouse doubt as to whether the 1940 act can effectively protect investors and still promote the policies of the SBIA.

The effect of applying the 1940 act to SBICs may be illustrated by analyzing specific provisions of the act. First of all, the 1940 act prohibits registered investment companies from using voting trusts and allows proxy voting only in accordance with SEC regulations.

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99. Numerous tax advantages are afforded to SBICs and those who invest in them. First of all, stockholders in an SBIC are allowed an ordinary rather than a capital loss deduction for losses on the sale or exchange of SBIC stock. Treas. Reg. § 1.1242–1(a) (1960). Second, the SBIC itself is allowed an ordinary loss deduction for losses incurred in the sale or exchange of the convertible debentures or stock obtained from a small business. INT. REV. CODE OF 1954, § 243. The SBIC is also granted a 100% deduction for the dividends which it receives from small businesses. INT. REV. CODE OF 1954, § 243(b). In addition, the SBIC is exempted from the personal holding company surtax. Treas. Reg. § 1.542(c) (1960). Finally, earnings and profits of the SBIC are not subject to the accumulated earnings surtax if they are reinvested in small business loans and convertible debentures. Treas. Reg. § 1.533–1(d) (1960). See Evans, Developments in Small Business Law, 15 BUS. LAW. 979–80 (1960); 14 BUS. LAW. 1152–53 (1959), for a further discussion of these tax advantages. See S. REP. No. 1293, supra note 98, at 17–18 for a discussion of proposed changes in tax law which relates to SBICs.
100. See S. REP. No. 1293, supra note 98, at 21.
101. In regard to these differences, George Miller Jr., President, Baltimore Investment Company made the following statement:
You might say that the 1940 Investment Company Act was designed to regulate companies which naturally and spontaneously sprang into being to help enlarge and enhance the existing equity capital facilities of big business, while the Small Business Investment Act of 1958 was found necessary to initiate equity capital facilities for small business.
Hearings, supra note 91, at 237.
vent the abuses which resulted when individuals with little personal investment used voting trusts and proxies to gain control of a company. For example, as described earlier, brokers often gained control of investment companies, and used such control to enhance their own brokerage businesses rather than to benefit the shareholders of the investment companies. Since brokerage profits are derived primarily from purchasing and selling securities, it would seem unlikely that a broker would gain substantially from controlling an SBIC because its investments consist largely of small business securities which usually are not readily marketable.

Another abuse which the 1940 act sought to prevent was the use of voting trusts and proxies in order to pyramid and, thus, gain substantial control over a complete industry. But since SBICs invest only in small business securities it is unlikely that substantial control over a significant industry could be obtained through an SBIC. Of course, it is possible that the abuses relating to proxies and voting trusts could occur in an SBIC. However, if a small business is to be aided effectively, restrictions should not be placed on SBIC operations until the possibility of these abuses materializes or at least threatens to materialize. The 1940 act, as now applied to SBICs, imposes restrictions on the functions of an SBIC whether the abuse sought to be prevented is a mere possibility or presents an actual danger.

A further example of the restrictive regulation of SBICs is found in the 1940 act's requirements that securities owned by an SBIC be held under a custodial agreement. In order to satisfy the custodial requirement, the SBIC must deposit its securities with a bank or with a company which belongs to a security exchange, or it must retain them in accordance with SEC rules. These SEC rules may require segregation, hypothecation, earmarking, or inspection of an SBIC's security holdings. The apparent reason for this provision is to restrict access to a company's securities and, thus, prevent certain individuals from using the securities for their own benefit. For example, a favorite profit-making device of investment company brokers was to buy and sell securities at a rapid rate without regard to the necessity of such action in order to realize the brokerage commissions paid by the

107. Ibid.
108. Ibid.
investment company. The fact that most securities held by mutual fund investment companies were extremely liquid and negotiable made it easy to accomplish such an abuse. This custodial provision not only handicaps an SBIC by limiting its access to the securities it holds, but also, the SBIC is forced to incur additional legal counsel and custodial expenses in order to comply with the provision. Furthermore, the burdens imposed on SBICs by the custodial requirement are not justified since the danger of mishandling the securities of an SBIC is reduced substantially by the fact that SBICs invest in small business securities which are relatively unmarketable.

Probably the regulation most harmful to SBICs is the 1940 act provision which prohibits investment companies from issuing stock options unless they are issued ratably to a class or classes of the company's security holders and expire within 120 days of the date of their issue. As a result, SBICs which come under the 1940 act are not allowed to use stock options as a means of compensating their executives. The stock option, however, is an extremely valuable means by which the newly formed SBIC can obtain the experienced executives needed to guide the company's development. Many embryonic SBICs are unable to pay their executives competitive salaries because of a lack of cash. Stock options provide these companies with a means of adequately compensating their executives. They are also beneficial to the SBIC which is able to pay adequate salaries because the company can retain its cash for use in small business investments. Moreover, most experienced executives prefer stock option compensation rather than cash because the option allows them to participate in the future prosperity of the company—the product of their own labor. Thus, since other businesses use stock options, SBICs under the 1940 act may be placed at a disadvantage in their attempts to secure and hold experienced executives. However, many persons consider stock options undesirable because additional shares of stock are thereby issued while the total assets of the company do not rise proportionally. Thus, there is a dilution of stock which existed prior to the option issue because the asset value of each share is reduced. It is also argued that insiders may be able to

110. See H.R. REP. No. 2639, supra note 8, at 8.
111. See Note, 41 COLUM. L. REV. 269, 292–94 (1941).
112. 54 Stat. 819 (1940), 15 U.S.C. § 80a–18(d) (1958). One exception to this rule is that an option may be issued for outstanding options in connection with a plan of reorganization. Ibid.
113. See Hearings, supra note 56, at 38, 90 & 161.
114. See Hearings Before Subcommittee No. 3 of the Committee on
manipulate control of the company by issuing stock options to specific individuals so that they might thereafter hold a majority of the company's outstanding shares. But these objections could be satisfied by amending the SBIA to provide that the shareholders must approve all stock options issued by a company; thus, shareholders are afforded an opportunity to protect themselves against any abusive use of the option by insiders.

These provisions of the 1940 act point out the possible arbitrariness of applying the 1940 act to the SBIC. There is little doubt that SBICs are subject to the same type of abuse which the 1940 act sought to prevent among mutual fund investment companies. But the primary purpose in formulating the 1940 act was to protect investors in mutual fund companies. On the other hand, the interest in investor protection must be balanced against a second interest not encountered in mutual fund companies—that of encouraging the formation and development of SBICs so that they might aid small business. Thus, it is difficult to assert dogmatically that the provisions of the 1940 act should apply to SBICs without considering the strong policy favoring SBIC growth. It would seem that the provisions of the 1940 act are too inflexible to apply to SBICs without considering their individual problems.

B. The Effect and Desirability of the Dual Regulation of SBICs Provided by the SBIA and the 1940 Act

Perhaps the most pressing reason SBICs seek exemption from the 1940 act is that it brings them within the jurisdiction of a second agency—the SEC. As a result, the following undesirable situation arises. SBICs which have less than 100 shareholders and do not have or contemplate a public issue of their securities are regulated by the SBID. However, if an SBIC attempts to expand by means of a public issue or by an increase in its total number of shareholders to more than 100, it comes within the provisions of the 1940 act and is therefore subject to the regulation of both the


116. See Hearings, supra note 114, at 47–48. Such a provision requiring stockholder approval of all stock option issues by a corporation is included in the Minnesota corporation laws. See Minn. Stat. §§ 301.14(6)–(7) (1957). However, some states provide no checks on the issuance of stock options. See Ballantine, Corporations 516 n.77 (1946).

117. See Ballantine, op. cit. supra note 116, at 512–16; Stevens, Corporations 523–25 (1949); Ballantine, Options vs. Ownership, 25 N.Y. S.B. Bull. 171 (1953) for a general discussion of stock options.


SEC and SBID. This latter situation requires an SBIC to comply with two sets of regulations which necessitates duplication of effort in particular situations. When a group of individuals desires to form an SBIC which comes within the jurisdiction of the 1940 act it must file statements concerning the proposed company which meet the approval of both the SBID and SEC. In addition, such an SBIC is required to file semi-annual financial reports with each agency; they require similar information. The SEC and SBID are authorized to require the keeping of such books and accounts as each shall deem necessary. Consequently, it is possible that a particular SBIC might be required to keep two separate sets of accounts in order to satisfy both the SEC and SBID requirements. SBIC officials claim that such duplication is expensive and time consuming—especially for the embryonic SBIC with little cash and a small clerical staff. The SBIC under the 1940 act is also required to submit to examination by both the SEC and SBID.

120. The 1940 act requires an SBIC to file a statement containing information concerning the proposed business policy of the investment company. In addition, the statement must include the names and addresses of the company's officers and directors and a disclosure of the business experience of each officer and director. See 54 Stat. 804 (1940), 15 U.S.C. § 80a–8(b) (1958). See notes 13–19 supra and accompanying text for a statement of the registration requirements under the SBIA.

See Hearings, supra note 91, at 148 for a listing of the typical forms required to be filed by an SBIC.

121. The 1940 act requires that reports concerning the investments and condition of the SBIC as the SEC shall require must be filed with the SEC. See 54 Stat. 836 (1940), 15 U.S.C. § 80a–29(b) (1958). The SBID requires that such information as it shall require concerning the SBIC's activities and the securities it holds shall be filed with the SBID. See 13 C.F.R. § 107.308–5 (1959). As a result the SBIC is forced to make two different disclosures although essentially the same information is required by each agency. The burden of this disclosure would be considerably lightened if both agencies required identical reports because only a duplication of a single report would have to be made.

Section 308(c) of the SBIA provides that the SBID may exempt SBICs registered under the 1940 act from reporting requirements to the extent necessary to avoid duplication in reporting requirements. See 72 Stat. 695, 15 U.S.C. § 687(c) (1958). However, the practical operation of this section offers little relief to SBICs from dual reporting and filing requirements. Since the SBID has substantial regulatory power and responsibility over SBICs, it is naturally reluctant to abdicate this power which facilitates the discharge of its duties.

122. 54 Stat. 836 (1940), 15 U.S.C. § 80a–30 (1958) (authorizes SEC to require such accounts as it deems necessary); 13 C.F.R. § 107.302–3 (1959) (requires SBICs to keep such records consistent with good accounting principles).

123. See, e.g., Hearings, supra note 91, at 148.

In addition such an SBIC must have loans to its "affiliated persons" approved by both the SEC and SBID.\footnote{125} As a result of this duplication of control, SBICs are discouraged from expanding\footnote{127} and investors are reluctant to form, and to invest in, SBICs.\footnote{128} Both of these results are clearly contrary to the SBIA's purpose of encouraging the development of SBICs.\footnote{129} Furthermore, most SBIC managers agree that a company must have access to large resources in order to serve its customers adequately.\footnote{130} Certainly, it is difficult to amass large resources without coming under the regulatory provisions of the 1940 act. However, the resulting dual regulation might well deter an SBIC from expanding and reaching its optimum point of satisfactory operation.

However, the most burdensome situation which results from dual regulation arises when the two agencies issue conflicting regulations on the same problem. These complications are illustrated by each agency's regulations concerning stock options. The SBID has provided that SBICs under its jurisdiction may utilize stock options to compensate their employees.\footnote{131} However, as stated earlier, the 1940 act does not allow stock options to be used for this purpose.\footnote{132} Consequently, an SBIC not within the jurisdiction of the 1940 act may use stock options as a means of compensating its employees. But the same SBIC will be precluded from issuing further stock options when it later contemplates a public issue or expands its list of stockholders to more than 100. As a result, an SBIC's right to issue stock options is not determined by balancing the need for such a compensatory device in promoting


\footnote{127} See Hearings, supra note 91, at 159–61.

\footnote{128} Id. at 162–63.


\footnote{130} See, e.g., the testimony of Charles E. Salik, President, Electronics Capital Corporation, San Diego, California, before the Select Committee on Small Business where he states that five million dollars is the minimum economic size for an SBIC. Hearings, supra note 56, at 40.

The main reason an SBIC needs large resources is the fact that the SBIA provides that an SBIC cannot loan more than 20% of its total capital and surplus to any one small business concern without the approval of the administration. 72 Stat. 694, 15 U.S.C. § 686 (1958). Thus, in order to satisfy the substantial needs of a single concern, an SBIC must have large resources.


Although the SEC has power under § 6(b) of the 1940 act to exempt SBICs from this provision, it has steadfastly refused to do so. See Hearings, supra note 91, at 29–31.
the growth of the SBIC against the need for investor protection. Instead, it is determined by the arbitrary factor of whether the SBIC contemplates a public issue or has more than 100 shareholders. Such an arbitrary classification fails to weigh the relative merits of the stock option device as used by an SBIC.

Another problem is posed by the SBID's and the SEC's inconsistent views on stock options issued by an SBIC prior to its coming within the jurisdiction of the 1940 act. Edward N. Gadsby, former chairman of the SEC, believes that when an SBIC comes under the coverage of the 1940 act it would have to make arrangements to eliminate its stock options.\(^3\) If this view is adopted, an SBIC with a stock option plan will be forced to violate such agreements with its executives in order to comply with the act. Therefore, SBIC executives fearing loss of their stock option rights might well be encouraged to oppose any expansion plan which might bring them under the 1940 act. If such a conflict of interest materializes, it is likely that SBICs will find it difficult to develop properly.

C. The Desirability of Placing Sole Regulatory Control of SBICs in One Agency

As a result of the difficulties which arise when the 1940 act is applied to SBICs, it has been suggested that the regulation of SBICs be centered in one specialized regulatory body. At present, since responsibility for regulating SBICs is placed in two agencies, the SBIC is subjected to two regulatory policies. For example, the SEC's major concern with SBICs coming within its jurisdiction is the protection of investors.\(^3\) The SEC is not responsible for the over-all development of the SBIC program. As a result, its regulations are likely to favor the investor to the detriment of SBIC development. On the other hand, SBID regulations extend to all areas of the SBIC program. In addition to its rulings concerning the SBIC's general business operation,\(^3\) the SBID issues regulations providing for investor protection.\(^3\) Therefore, the SBID, in formulating its regulations, is likely to weigh the interest of investor protection against the need to provide an atmosphere conducive to the formation of SBICs; thus, all phases of the SBIC program will be effectively implemented.

133. See Hearings, supra note 114, at 98.
134. See notes 50–52 supra and accompanying text.
135. See notes 33–37 supra and accompanying text for a discussion of this type of regulation.
136. See notes 141–43 supra and accompanying text for examples of this type of regulation.
A second reason for centralizing the regulation of SBICs in one agency is the need for individualized regulation. The type of investments made by different mutual fund companies are relatively uniform and, thus, the arbitrary provisions of the 1940 act can satisfactorily regulate these companies. However, the investment policies of any two SBICs are seldom the same. SBICs are usually formed by individuals possessing talents in a particular industry. For example, SBIC officials familiar with the chemical industry ordinarily will concentrate their investments in that area because they are better able to deal with and understand the needs of chemical firms. Each SBIC must adjust its methods of financing and operating the needs of the small business it seeks to aid. As a result, SBICs develop individual problems which are often quite different from those of mutual type investment companies. Therefore, SBICs require regulation by an agency which is familiar with the general problems of small business. In addition, the regulatory agency should be empowered to exempt an SBIC from particular regulations, if as a result of the exemption, that company's development will be furthered without subjecting the SBIC to the harms sought to be prevented by the regulation. Such a system of regulation would clearly promote SBIC development more efficiently than the 1940 act and still provide sufficient investor protection. As an alternative to centralization of regulatory power, it has been suggested that the existing regulation of the 1940 act be retained and Congress should exempt SBICs from certain provisions of the 1940 act. But this would not solve the basic need of SBICs for regulation by an agency which can mold its policies to fit the individual needs of the particular SBIC. Only an agency with extensive knowledge, experience, and flexibility in handling SBIC problems can perform this function satisfactorily. Certainly Congress does not possess such knowledge or experience nor could it act with the necessary flexibility.

CONCLUSION

The SBID seems to be the agency best equipped to provide both centralization and flexible regulation. The SBID currently has complete responsibility for the formation and growth of SBICs and, thus, it is in the best position to understand and provide for the needs of small business. It has been contended that the SBID is neither capable of, nor experienced in, providing SBIC investors

137. See Hearings, supra note 91, at 232–33.
138. See Hearings, supra note 114, at 94–95.
139. See notes 11–12 supra and accompanying text.
with proper protection.\textsuperscript{140} But the SBID established its concern for SBIC investors when it issued regulations for their protection. For example, SBID regulations allow an SBIC to issue only one class of stock,\textsuperscript{141} and require that a particular SBIC's ratio of indebtedness to paid-in capital and surplus shall not exceed four to one without SBID approval.\textsuperscript{142} The SBID requires that an SBIC submit financial statements covering its operations to its shareholders every six months.\textsuperscript{143} Moreover, the SBID already has personnel trained by the SEC in the SBID's programs of investor protection.\textsuperscript{144} Thus, the SBID would not be required to assume any unfamiliar duties if it was given complete power to regulate SBICs. Also, regulations issued by the SBID with complete responsibility for the SBIC program would have the added virtue of being formed with a broad view as to what is best for the SBIC program as a whole as well as for the investor. In addition, the burdens of dual regulation and the dangers of conflicting regulation would be eliminated. Instead one philosophy for regulating the complete SBIC program would emanate from one agency—the SBID. Certainly the promotion of SBICs and the protection of their investors can best be obtained by such a result.

\textsuperscript{140} See the testimony of Edward N. Gadsby in \textit{Hearings, supra} note 114, at 96.


\textsuperscript{142} See 13 C.F.R. \textsection 107.303-1 (1959).

\textsuperscript{143} See 13 C.F.R. \textsection 107.302-3 (1959).

\textsuperscript{144} See \textit{Hearings, supra} note 91, at 231.