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SMALL BUSINESS ACCESS TO EQUITY AND VENTURE CAPITAL

HEARINGS
BEFORE THE
SUBCOMMITTEE ON CAPITAL, INVESTMENT AND BUSINESS OPPORTUNITIES
OF THE
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES
NINETY-FIFTH CONGRESS
FIRST SESSION

WASHINGTON, D.C., MAY 12 AND 18; AND
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OPENING STATEMENT OF CHAIRMAN LAFAULCE

Mr. LaFalce. I understand other members of the subcommittee are on their way here. The ranking minority member, Mr. Stanton, is at the White House right now and should be here shortly, but because I am anxious to proceed on this important issue I am going to take the liberty of proceeding, in anticipation that the other members will be walking in shortly.

First of all, I want to apologize for the room but I did want to begin hearings immediately. We delayed them somewhat from a previous tentative date, and this is the only room available this entire week. There are so many hearings going on, at least at a time when I would be able to convene the hearing.

My secretary just walked in with my briefcase and told me that she was in the elevator with Charlton Heston. She advised me that the hearing room where he is testifying is considerably larger. I am not sure that the issue is larger but the interest in him is a little greater than the interest in this proceeding.

On the other hand, the smallness of the room will provide us with a certain informality.

This morning the subcommittee commences its exploration of the venture and equity capital markets accessible to the small business community. The availability of different types of capital for small enterprises is perhaps the single-most important subject matter within our jurisdiction, and the subject is all the more compelling due to widespread evidence that the availability of essential capital for new and growing concerns is not keeping pace with the demand.

The SBA has quite naturally been very concerned about the shrinkage of capital supply, and last year commissioned a special task force to analyze the causes of the shortage of venture and equity capital and develop some proposals to help ameliorate the current situation. “The
Report of the SBA Task Force on Venture and Equity Capital for Small Business,” which was published in January of this year, provides the subcommittee with an excellent departure point for further discussion on this problem area. I would like to congratulate the members of the task force, a good number of whom are here this morning, as well as the SBA personnel who worked with them, for an excellent job in coming to grips with the difficult issues and advancing some worthwhile proposals.

There are essentially three principal sources of venture capital for small businesses: The private savings of the individual businessman; private venture capital investment companies; and the small business investment companies licensed by the SBA.

Because the small innovative entrepreneur is typically without sizable assets and cannot demonstrate a proven track record, at least insofar as his new product development is concerned, he is hard-pressed to obtain the type of long-term capital with flexible terms that he needs from commercial banks. Most banks make strictly short-term loans of 3 years maximum with fixed principal and interest repayment terms. Further, most banks prefer to stay away from lending to relatively new companies whose products are untested in the marketplace.

As a result, the businessman seeking investment capital for a new or growing venture must seek the capital he needs in a rather narrow marketplace. It is of great concern to this subcommittee that this marketplace appears to be narrowing even further, to the point perhaps of extinction.

It is significant, I think, that in their report the task force noted that the number of stock offerings made by companies having net worth of $5 million or less has fallen drastically from 548 offerings in 1969 to only 4 in 1975. That statistic frightened me. The data is frightening in terms of the statement it makes about the capacity of our risk capital markets to sustain and nurture small firms that have the potential for tremendous expansion and concomitant job creation.

In these hearings, the subcommittee will focus on the impediments blocking reasonable access to venture and equity capital for the small business concern. We will also be interested in exploring the limitations on the types of small firms that do have access to equity capital. It has been estimated that well over 50 percent of the existing stock of risk capital that has been available to small firms has been channeled to companies having high technology orientations.

In our commitment to address these issues in a constructive fashion we are joined by the Small Business Administration. I am delighted that the agency's new Administrator, Mr. A. Vernon Weaver, has recognized and stated that “The most important financial problem small business faces today is the lack of access to venture and equity capital.” It is my sincere hope that the subcommittee will be able to work closely with the Administrator and the agency to jointly consider and initiate the types of legislative and regulatory modifications that may be necessary to improve the investment climate for small business concerns.

Mr. Stanton, the ranking minority member, did have a prepared statement. In his absence I would ask Mr. Kasten to read it for him.

Mr. KASTEN. Thank you. I am very glad that you have scheduled
hearings on one of the most important problems confronting the small business community today. If free enterprise is desirable, and most of us here think that it is, it certainly needs strengthening. Probably the last remaining real entrepreneur is the small businessman. He is the one taking the risk. He is the capitalist. We certainly should try to find ways to encourage and promote the availability of capital for him.

The key to the future economic well-being of the United States lies in increased capital formation, that is, the investment of savings in factories, equipment, and new technology. These are productive investments, and are the source of jobs and income.

I am confident that the distinguished list of witnesses who will testify before us on this matter can shed light on the problem and advise us in finding a proper path through the thicket of laws and regulations so that we might make it easier for our enterprising business people to do the things that will profit them, and in so doing provide work for others and thereby help our country.

Mr. LaFalce. Mr. Weaver?

TESTIMONY OF A. VERNON WEAVER, ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION; ACCOMPANIED BY PETER MCNEISH, ACTING ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT

Mr. WEAVER. Thank you. On my right is Pete McNeish, Acting Associate Administrator for Finance and Investment which had a lot to do with the task force.

Mr. Chairman, I have said previously that the lack of capital opportunities for small business is the most important financial factor. For that reason I have a relatively long statement and at your pleasure I will read only parts.

Mr. LaFalce. Without objection, it will be placed in the record.

[The full prepared statement follows:]
In summary, the Task Force has told us that in today's financial marketplace a series of serious impediments preclude small business from competitive access to needed capital.

As a result of recent economic experiences, private investors—individuals who were once a vital source of funds for new businesses—have become quite reluctant to provide risk funds for new or growing small businesses. And the situation is further compounded by legislation and regulations which are disincentives to risk sharing.

Public offerings by small companies have all but dried up in recent years, and this has been further compounded by the skyrocketing costs of entering the public markets.

At the same time, the trend toward concentration of funds in larger institutional investors is clear. Because these institutions either follow relatively conservative investment policies, or are restricted by governmentally imposed investment standards, the net result is a further restriction on access to these funds by small business ventures.

I won't go further in elaborating on the clear picture painted by the Task Force. The net reality, however, is that small business is slowly being foreclosed from access to "risk capital" which is desperately needed for starting and expanding those small companies.

As President Carter has told me, more loans—or more debt capital—is not what an already overly debt-burdened company needs. More loans will simply put these companies out of business. What they need is some form of risk capital that will stay with these companies over time and help assure their orderly growth.

THE CHALLENGE

Studies such as that recently done by the M.I.T. Development Foundation, have shown that, on a relative basis, new and expanding small firms generate more jobs and income tax revenues than larger, more mature companies.

Our challenge, then—yours and mine together—is to find the keys which will help to remove these impediments for the millions of new and growing small businesses in America so they, in turn, can continue to infuse innovation and create new jobs and generate new revenues.

TASK FORCE RECOMMENDATIONS

The Task Force has made a series of some nineteen (19) recommendations dealing with SBA programs, taxes, securities laws and regulations and institutional investments. A number of these are quite complex and technical, and I understand the Task Force also considered a host of other ideas during the course of its deliberations.

I will discuss first the recommendations relating to SBA, and then those dealing with other matters.

SBIC RECOMMENDATIONS

As I have indicated in my previous testimony, the Small Business Investment Company (SBIC) program is one of the remaining primary sources of risk capital for small business.

In my opinion we should substantially enlarge the SBIC program in order to attract the large volume of risk capital required by small business. This may entail fundamental changes in the SBIC program to attract an increased flow of funds into the program by large institutional investors and other private sources of capital.

The Task Force has made several specific recommendations regarding the SBIC program and I will address each separately.

In order to help overcome the heavy burden of debt service an SBIC must carry when leveraged through government borrowing at a 3:1 or 4:1 ratio, the Task Force has recommended that the portion of government debt which is used for equity investments be provided to the SBIC on a subsidized basis.

Although the Task Force did not specify a rate of subsidization, I am opposed to the subsidized approach as a matter of principle, and because of the negative budget impact involved. The Congress has provided a limited form of subsidy to 301(d) SBICs (commonly referred to as MESBICs), and I agree with this approach in light of the special nature of the businesses they deal with, namely firms owned by socially and economically disadvantaged persons. However, in
my judgment a subsidy for regular SBIC's would partially destroy the principle strength of the program—that of private investment companies making private investment decisions in the competitive marketplace. Subsidized borrowings would be tantamount to excessive government intervention in this process and would help to destroy the concept.

As an alternative, the SBA is now working on an approach to a revision of the structure of SBIC borrowings which, we believe, will achieve very much the same result without the need for a subsidy.

The Task Force has also recommended a substantial increase in the size standards for companies in which SBICs can invest, and an indexing of those size standards to allow for future size adjustments according to market factors.

As I understand the recommended size standard increase, it is based on the contention that:

Financial markets and economic conditions have changed dramatically over the last several years to the extent that many medium size companies are trapped between being too big to be financed by SBICs, yet too small to obtain funds in the public markets, and

Increasing the size standards would allow SBICs a greater opportunity to make more highly liquid "venture capital", income producing investments which would, in turn, allow them greater latitude to make lesser-yielding investments in small companies.

The size criteria for the SBIC program were modified in 1975 when the asset test was increased from $5.5 million to $9 million, the net worth set from $2.5 million to $4 million and the after tax earnings standard from $250 thousand to $400 thousand. The employment standards for manufacturing companies have remained substantially the same since the SBIC program was created in 1958.

I am generally in sympathy with the Task Force's recommendation on the size standard increases, and I have initiated a study of the economic factors involved to determine to what extent these standards can be legitimately raised. As to the indexing portion of the recommendations, this too seems like a sound idea and I have instructed my staff to study the indexing approach and give me recommendations in the very near future.

The Task Force also recommended that SBICs be permitted a deduction from ordinary income for loss reserves on the equity portion of their portfolios. Since this is essentially a tax matter, I will discuss it later in conjunction with other tax proposals.

SBA GUARANTEED LOANS

While recognizing the inherent value of SBA's guaranty loan program, the Task Force recommended that SBA should require commercial banks to assume a larger portion of the risk—by providing a guaranty percentage of less than 90 percent—and that SBA should change its one-time 1 percent guarantee fee to an annual fee reflecting the value and cost of SBA's guaranty.

While I have not made a complete analysis of what impact these changes would have on the program, my initial conclusion is that the reduced guaranty percentage would be a disincentive to bank participation and could result in a reduction of the volume of loans to small business borrowers. As I have previously testified, we have under study the alternative approach of an insured loan program.

SBA'S SECONDARY MARKET PROGRAM

The Task Force recommended that we substantially expand our Secondary Market Program by creation of a "certificate" system for the sale of SBA-guaranteed loans.

As you know, we have made substantial progress in developing our secondary marketing system over the past two years, and guaranteed loans are now being sold by participating banks at an annual rate of some $300 million.

Progress to date has been achieved primarily by streamlining a still too cumbersome sales procedure. The next logical step is a more simplified certificate system which will allow for the sale of a guaranteed portion of a loan just as though it were a freely transferable market security. We have a few remaining obstacles to overcome, but soon should have a certificate system in place which has the potential of substantially enlarging our secondary market sales. The great value of the system, of course, is that it provides liquidity to the banks during times of tight money, and the proceeds may be reinvested in small business.
In order to make these securities more attractive to investors, we now have under consideration the modification of the nature of our guaranty so that it would be a guaranty of "timely payment of principal and interest" rather than the current guaranty of repayment in case of default.

**TAX, SEC AND ERISA RECOMMENDATIONS**

When considered as a group, the Task Force recommendations relating to tax policy changes, modifications of SEC laws and regulations and changes in the Employees Retirement Investment Securities Act, (ERISA), are designed to do two things:

1. To increase the opportunity for small business to generate capital through retained earnings, and
2. To provide a substantial set of incentives to the investment community to invest an increased share of their capital in small business ventures.

Certainly these are laudable objectives which I strongly endorse in principle. However, since these proposals clearly involve policy issues affecting several agencies, Treasury, Labor ad S.E.C., and have potential revenue and budget impact, they will require further study by the new Administration.

I intend to pursue these recommendations with the White House, the Office of Management and Budget, Treasury, Labor and the S.E.C.

**CONCLUSION**

In conclusion, let me repeat that I believe that the availability of "risk capital" is the most pressing financial problem facing small business today. We need to remove those impediments which stifle the growth of small business and work toward a rational system of financing that will give small business equal access to the market sources of capital.

In my judgment, continued flows of capital investment into small business is crucial to the creation of jobs and the vitality of our economy.

I look forward to working with you on finding solutions to the "Risk Capital" problem for small business.

Mr. Weaver, I welcome the opportunity to appear as the first witness before this newly established Subcommittee on Capital, Investment and Business Opportunity.

You are to be commended for the establishment of this new subcommittee which will focus on the issue of investment capital for small business.

As I have already indicated on several occasions in my previous testimony, in my view the most important financial problem small business faces today is the lack of access to venture and equity capital.

The venture and equity task force did an excellent job in analyzing this problem and presenting it in clear and precise terms.

Their report was completed in January of this year, and transmitted by my predecessor to each member of the Small Business Committees of the House and Senate, other committees of the Congress having an interest in the subject, and to key officials in the executive branch.

In summary, the task force has told us that in today's financial marketplace a series of serious impediments preclude small business from competitive access to needed capital.

Public offerings by small companies have all but dried up in recent years, and this has been further compounded by the skyrocketing costs of entering the public markets.

At the same time, the trend toward concentration of funds in larger institutional investors is clear. Because these institutions either follow relatively conservative investment policies, or are restricted by gov-
ernmentally imposed investment standards, the net result is a further restriction on access to these funds by small business ventures.

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The task force has made a series of some 19 recommendations dealing with SBA programs, taxes, securities laws and regulations, and institutional investments. A number of these are quite complex and technical, and I understand the task force also considered a host of other ideas during the course of its deliberations.

I will discuss first the recommendations relating to SBA, and then those dealing with other matters.

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In my judgment, continued flows of capital investment into small business are crucial to the creation of jobs and the vitality of our economy.

I look forward to working with you on finding solutions to the "risk capital" problem for small business.

Mr. LaFalce. Thank you very much, Mr. Weaver.

You have indicated that we could substantially enlarge the SBIC program.

Mr. Weaver. Of course.

Mr. LaFalce. This may entail some fundamental changes in the program. Could you give me an idea of what those fundamental changes could be. Are they among the recommendations of the task force or do you have some other ideas?

Mr. Weaver. Both, Mr. Chairman, one of the things I hope to do, and this would not necessitate a change, is to greatly broaden the sources of capital of the SBIC program. The place that I look to first is the insurance industry from which I came. There is relatively no insurance interest in the SBIC program. I think six or seven insurance companies out of the several thousand are involved. I hope that I can involve particularly the large mutual companies who have large cash flows.

There are impediments that are technical and I am going to address them. There are rules that need to be changed.

Mr. LaFalce. Would any of those impediments be under the jurisdiction of the Small Business Committee?

Mr. Weaver. I don't think so since the insurance industry is regulated by the States. It is State insurance commissioners and their associates that I need to talk to. Mr. McNeish may have something to add.

Mr. McNeish. I think the answer at the moment, Congressman, is we are taking a look with our advisory council in the SBIC program, taking a look at the nature of the program and its current structure to see if we could alleviate some of the problems, particularly the debt service problem that the SBIC has in terms of their current borrowing from the SBA.

Our analysis reveals that the leverage of 3:1 and 4:1 levies a substantial burden on the SBIC and the impacts on the SBIC in terms of its ability to reinvest their funds in equity. So, we are taking a look at that in terms of the structural problems involved. I think down the road further, analysis may reveal some other possible changes that might be necessary.
In short, most of those issues are under study and will receive some additional analysis.

Mr. LaFalce. One of the recommendations of the task force is that some portion of borrowed funds used for equity investments take the form of debt with the interest partially subsidized.

Do you favor guaranteeing that debt? Do you favor subsidizing the interest?

Mr. Weaver. Subsidizing the interest concerns me, Mr. Chairman. I am very much in sympathy with the fact that when we are loaning money to an SBIC and require them to pay interest to us and they in turn are using that money to furnish equity capital to a small business and may have no return for many, many years, it creates a problem for SBIC. What the answer is to it I have not really formulated and the studies will give me a better position.

Mr. LaFalce. Has the SBA made any analysis of the burden of the debt service because of increased leverage that is available.

Mr. McNeish. We have the beginnings of a computer analysis underway now. I don't want to give you any conclusive answers at the moment but the preliminary conclusions are that when an SBIC reaches the third dollar leverage point, and if the SBIC is in turn attempting to put those funds in equity type investments, then it is extremely difficult in the short term to meet those debt services, literally impossible in some cases.

I suspect we will have that analysis completed within the next 3 or 4 months and it will give us the kind of indications of where we are going with the debt structure for SBIC's.

Mr. LaFalce. Well, if we don't have a partial subsidy then there is that problem. What are the alternatives?

Mr. Weaver. What is needed in my opinion is for SBA to use an advocacy approach to persuade them it may be in their best interest and the interest of the country to infuse the SBIC with equity money themselves. I think that is the answer, to find a source of equity for them so that they can provide equity for small businesses.

Mr. LaFalce. Mr. Weaver, a rather broad question: I consider SBIC's important, but yet in the total scheme of things what percentage of equity or capital is provided by them? It is my understanding that it is a small percentage, maybe 1 percent of the total. Is that not true?

Mr. Weaver. I am not sure that is true today.

Mr. McNeish. I think you may be referring to some statistical analysis that was done and I have seen that same statistic. I think that those 1 percent or 2 percent figures relate to total investment capital—both loans and debt included—in small businesses. Again, we have the same data problem. It is difficult to aggregate factual and conclusive figures on total capital being invested in business today. I would surmise that the SBIC's percent of that together with private venture capital is substantially larger than 1 or 2 percent. You get into the questions, I think, of the definition as to what constitutes venture capital and in what part of that universe are SBIC's investing. But it is far greater than the 1-percent figure reflected in, I think, the previous testimony you are referring to.
Mr. Weaver. If I can add to that. The administration's position is that the equity capital to small business should come from the private sector, overpoweringly so. I don't have that statistic to prove what I am going to say but I think now with the private sector's inability to refuse to provide that equity to small capital that the SBIC's are provided a greater portion than the administration would care to see them provided. It is a question of—it has actually happened.

Mr. LaFolce. The thrust behind my question was that while we have a specific responsibility on this committee and you have a specific responsibility as Administrator to make sure that we develop the SBIC concept to its full potential, and we will do that, by the same token we also have an advocacy role insofar as other laws are concerned and other committees and other departments or agencies. We have to give certain priorities of time. Shall we be spending more of our time and effort in continuing the surtax exemption, for example, rather than this change in the SBIC? We try to keep these things in perspective. That is why I am extremely interested in the advocacy role that your Agency will play with the other departments regarding some of these recommendations. That is why I was interested that you intend to pursue this in the While House, Treasury, Labor, and SEC, because I think perhaps the greatest role of the SBIC and the greatest role of the Small Business Administration is an advocacy role as far as the changes in the tax laws are concerned, in ERISA laws, security laws and regulations, et cetera. They are not going to call us and tell us what the problems of small businesses are. We are going to have to actively go out. To my knowledge this task force report has drawn little or no attention prior to this time. I saw a mention of it once in a Forbes magazine article. I don't know if anybody else saw it.

I do know that at meetings of other committees on which I serve I made reference to the report to previous secretaries and to Chairman Shultze and they were not aware of it. I sent Mr. Shultze a copy, et cetera. I think that is a very, very important part of all our jobs.

Now that I have used up more than 5 minutes of my time I will turn over to Bob Kasten.

Mr. Kasten. Well, the chairman can keep the time.

Mr. Weaver, about the problem that private capital has all been drawn up in recent years and the chairman mentioned in his statement that the number of stock offerings has fallen drastically from 1969 to 1975. I am sure that is the case but if you look at what has happened in the market isn't it true that the number of stock net worth would have dropped quite drastically. We have gone through the change in small business. Is it the other way or is it small companies that have lost the most or is it just that?

Mr. Weaver. Yes. First, in 1970 and 1974 all companies had, but over the span of time, I would say the last 2 years, large companies have had no trouble raising capital and of course, they have other places to go to in the market and small business has consistently been the one to suffer.

Mr. Kasten. So, it is a fact that the small businesses with a net worth of less than $5 million, have been in a decline; that their trend has gone against the market, if you will.

Mr. Weaver. Yes.
Mr. KASTEN. There has been much said about elimination of double taxation of capital dividends and that the removal of this double taxation would stimulate capital formation. What is your position and the position of the administration on the elimination—I understand this isn't only a small business problem, but what is your position personally and then what is the position of the administration on the exemption or the double taxation of dividends?

Mr. WEAVER. The administration's position is that it would be better to do away with it. It would not help small business.

Mr. LaFALCE. Which administration, the Small Business Administration or the Carter administration?

Mr. WEAVER. No; the Carter administration, but in my opinion this eliminating of this double tax would not help small businesses.

Mr. KASTEN. Would it hurt small business or would it have no effect?

Mr. WEAVER. I think no effect. It has some effect but most small businesses are using capital to reinvest in their business.

Mr. KASTEN. Wouldn't it be best if the taxation was on the individual receiving the dividend or the tax remaining on the corporation? Which side do you think ought to be taxed?

Mr. WEAVER. I really don't think it makes much difference because they reinvest the money.

Mr. KASTEN. Another question that has been in some of the legislation that has been proposed is that of a graduated corporate income tax. Is the position of you and the Carter administration in favor of a graduated corporate income tax?

Mr. WEAVER. I can't speak for the Carter administration because we have not discussed it, but it is something we want to recommend.

Mr. KASTEN. I do not think anybody questions the need for equity, but the reason we focus on that, when we are talking about small business and equity instead of a combination of equity and debt capital is that most small businesses have debt capital as well as equity capital. How has the traditional emphasis on debt capital for small businesses worked against or not served small business communities?

Mr. WEAVER. Well, debt capital in the small business community is served by our 7(a) program which is a large lending program that has experienced the highest 2 months in its history, the last 2 months. It is just growing by leaps and bounds. I think we are doing a reasonably good job of supplying debt to small business where needed. That is why I said that the lapse has gone. You need both, and all we have is a chance to offer debt.

Mr. KASTEN. The task force report has recommended on page 11 that commercial banks be required to assume a greater share of the risks in long-term financing. Are you aware of the problem in trying to do this under the SBA accelerated bank trial program? You have gone into this and it is my understanding that it has not worked. Could you, No. 1, tell us what your experience has been and No. 2, why it has not worked and what makes you think it will work?

Mr. WEAVER. I don't think we can tell the commercial bank system of the United States what risks they should assume.

Mr. McNEISH. The accelerated bank program does not address the problem of a large portion of the risk. That particular program is not
designed to address that issue. What it was designed to try to do is speed up the processing of the loans. Essentially, we said to the banks if we set some preconditioned criteria and if the borrower meets those criteria he automatically can qualify for a guarantee. Whether the program has worked or not is now under study. It was a pilot program. The volumes are relatively low and this might be for several reasons. Our criteria might be much too tight. We are studying that now. There will be a decision of either continuation or dissolution very shortly.

Mr. Kasten. Maybe I am wrong. It was my understanding that you started trying to put a program in effect and essentially backed off to a pilot program because it didn’t work when you put it into effect. Is my information incorrect?

Mr. Weaver. That is incorrect. We started with a pilot program originally and maintain it on a pilot program basis. We have closed it down now to review the results of it to consider whether it should be expanded, curtailed, or ended.

Mr. Kasten. Even before you got into this pilot program hasn’t the SBA been trying to encourage or—I don’t want to use the word force, but I think encourage banks to take a greater amount of interest in small business. Hasn’t the SBIC been working before the program started?

Mr. Weaver. There is a continuing emphasis.

Mr. Kasten. To insure a greater and greater risk?

Mr. McNeish. The accelerated bank program was designed only to address the issue of loan processing time. Our national figures show that it takes up to 22 days from the time a loan hits the SBA to the time we approve it. That is the major issue that that program is addressing itself to. The question of increased risk by the banks, that is a continuing effort.

Mr. Weaver. You may be thinking of my predecessor’s insured approach which changed from a guarantee to insurance, and the banks would have as little as 50 up to 60, 80, and 90. That has not yet been tried.

Mr. Kasten. Thank you.

Mr. Marriott. I apologize for coming in late, but this is a subject very dear to my heart, having been a business consultant for a number of years, tax matters, and equity capital matters, and coming from an area where 64 percent of all of the jobs are provided by small business. So, I welcome this opportunity.

I want to ask a couple of questions. The people who are working in your department today, what are their backgrounds? Do they come from the private sector, or do they come up from HUD and HEW? Do they think in terms of small business or are they far removed? I ask that as a personal question.

Mr. Weaver. As far as I am concerned, I come from the small business community and never worked for Government. So, I think I am more generally toward small business. The persons I have coming aboard as associates, for the most part, I can say the same thing.

Mr. Marriott. I just quickly read your testimony, and I think I agree that just throwing money at small business is not the answer and stock offering certainly is not going to help most of them. And
the double elimination or double taxation on dividends is not the answer either.

What I am concerned about is what the role of the SBA ought to be. We just spent many billions of dollars for public works jobs. I am wondering if you have any gut feeling as to whether a program could be arranged where you could do away with that type of thing and channel that money into small businesses requiring them to hire some people and then using a management team to help. It seems to me most problems are management as well as capital.

Has that idea ever come across?

Mr. Weaver. Very definitely. I have testified before that I am frustrated by the lack of a data base. I don’t know, and I am going to find out how many dollars we spend to create a job. I hope to be able to testify to that one of these days.

I have a gut feeling that the SBA program might be the cheapest program in the Government in the area of job creation, and we are talking about that.

Also, I agree thoroughly, and the President is most adamant on this, that management assistance is the problem in many cases. He has directed me to greatly expand our management assistance program. He has made the statement that to his knowledge that in most cases our management assistance program comes into play when the company is already broke. He wants that stopped.

Mr. Marriott. I have also assisted many people in filling out the applications for an SBA loan. That has got to be somewhat of a joke in many cases. I am wondering what your feelings are of putting the SBA in the risk capital business rather than the guarantee business?

Mr. Weaver. That gives me a problem, sir. I don’t think that the SBA should be in the business of risking capital.

Mr. Marriott. Or at least modifying so we do not try to have a foolproof business where we invest the money. Do you see any problem with reducing the standards to qualify for a loan and being a little bit more lenient?

Mr. Weaver. That, of course, would require new laws. We are required to make the loans to assure ourselves that the loans will be repaid. That is by statute.

Mr. Marriott. We can make the laws here but the question is, does the concept turn you on or does it create more problems?

Mr. Weaver. Well, I have mixed feelings. I have discussed this with the President specifically. To loan money to a business that is not able to repay the loan may be a disservice to that business. I am not saying we should not perhaps relax our standards somewhat, but to loan money to situations that are just not going to be able to pay is a disservice.

I think that those companies, in our advocacy role, we should try to get more equity capital available.

Mr. Marriott. You mentioned in your testimony something about ERISA, which is another subject dear to my heart, as bad as it might be. In your experience—going beyond the business that is struggling, to the small business that is doing quite well, do you have any information that ESOP’s are in fact helping the business or are they causing them future trouble?
Mr. Weaver. I certainly don't have any figures on ESOP. It is an idea with merit. We are investigating it and are pretty close to saying that we can make SBA loans to assist employees in the ESOP process by making the company part of the loan. What the impact is I can't say.

Mr. Luken. I also apologize for being late. Therefore, I won't go into what may be duplicative, but with regard to the last comment about ERISA, do you find that ERISA is burdensome, on the investment aspect, which is mentioned in the task force report? Do you find ERISA unduly burdensome?

Mr. LaFalce. Your vote is right there. They are unanimous.

Mr. Luken. It was a very politic question to ask.

Mr. Weaver. It is certainly important.

Mr. Luken. But is it important?

Mr. Weaver. Yes; I do think the pension plans should be lightened. I think the worst thing that bothers small businesses is that imposing of the prudent man rule on management. They are terrified that they are going to be sued by their employees. They are afraid they will be dropped by their insurance carriers. That, for example, might be 2 cents a thousand dollars more. I think those burdens should be removed.

Mr. Luken. That is on the investment aspect, but what about the administration aspect?

Mr. Weaver. I have seen the forms. I have not personally filled one out. But I don't know that that can be changed very much. It is a burden but, nevertheless, the law is there. You have to comply with it. I don't think that form can be shortened to any great extent.

Mr. Luken. What are the reports that you are doing as to how ERISA is operating? Have they geared up? I am new here. My experience in the private field—very limited experience—was that ERISA, during the last year, wasn't very responsive.

Mr. Weaver. My experience before I came to the Government was that ERISA certainly recruits small business people, not only because of the "prudent man rule" which restricts the investments a trustee can make, but by the extension of ERISA to group life and health insurance.

Mr. Luken. I am asking about ERISA—the company.

Mr. Weaver. The Government?

Mr. Luken. Beneficial Guaranty Corp. Is that the name of it?

Mr. Weaver. I really cannot say.

Mr. Luken. We cannot get an answer out of them.

Mr. Marriott. Having a lot of experience in this, ERISA stands for "everything rotten since Adam." [Laughter.]

Mr. LaFalce. I think Secretary Blumenthal recently said something similar to that.

Mr. Marriott. I think it is the responsibility of this committee, but I suppose that it is also taken up in the Ways and Means. Small businesses are really in trouble under the ERISA. It is a bad scene.

I hope that this committee with the help of the SBA can do something to solve it. I don't know if Ways and Means is going to do anything.
I filled out every form. I have administered over 100 plans. It is ridiculous. I would hope that maybe we can take the initiative to do something about it.

Mr. LUKEN. I was trying to get some idea of about what kind of initiative. I will yield further if the gentleman has any ideas.

Mr. LAFALCE. We do have a good many witnesses we want to hear. But before we go on, I did want to make a few points as far as your presentation is concerned.

First, we are, in general, in concurrence with your point on the task force report. Therefore, I am especially interested in working with the SBA and the Office of Legislative Counsel in drafting tough legislation that this subcommittee would be introducing.

So, if you could go to the recommendations—I don’t think that I am asking you to ignore interest subsidy. I have considerable reservations as to that. I would like to work with you in drafting legislation: First, permitting SBA to allow reserves in equity loans to small businesses; second, implementing the recommendation for a substantial increase in the size standards for SBIC’s investment; and third, possibly even the annual revision of the standards, which you are now studying.

I would like to move rather quickly. I am not particularly enchanted to have an annual fee nor do I think you are.

I am very interested in your secondary market program and certificate system, and I have already asked Mr. McNeish for a detailed explanation of the steps the SBA would need to take to implement that. I am very concerned, though, about whether we can implement that kind of program and have it do much good without tremendously expanding the overall authority of the SBA.

I think you probably share that concern. If so, we are also going to have to do something about the authority.

You are reviewing your accelerated program. I just want to tell you that my finding is based upon talking with people both in the banking field and SBA. That may be the best program under 7(a) that you have initiated. The banks that participated in the experiment really like it. It is staff action. I doubt very much if the loss experience is any greater at all. It might do a lot of good to implement the 7(a) program.

I think it is extremely important that we develop the data that you are so interested in because I am very interested in it, too. I was one of the few Democrats that voted against the public works bill. When you think of the amount of that money and the time it takes and the long-term effect, or lack of it, in comparison with what we could have done with that amount if we used a different approach, I think if we could develop that data, working together we could convince the administration and Congress, perhaps, that we should be taking a different approach.

While the task force report has recommended changes in ERISA, the prudent man rule, and so forth, comments have been made that we have an investment problem but that only affects a small percentage of small business types. Most small businesses are affected by ERISA in a much different way. They have 10 employees. They have—however many it is, 30 individuals, set up a pension plan and then the small businessman decides, “OK, I will just not have a pension plan.
anymore.” The task force report was not charged with the responsibility of investigating that. So we do not fault it for that. But that certainly should be the responsibility of the SBA.

Before we continue on with any other witnesses, are there any other comments? [No response.]

Thank you very much.

The remaining witnesses are all members of the task force, and I think it would be best if, because of the constraints of time, we take your testimony as a panel. We are in session today at 11 o’clock, and although we will not conclude by 11 o’clock, we will be subject to the call of the bells.

Mr. Casey, you can have a seat here. Mr. Golder, Mr. Hambrecht, Mr. Lea, and Mr. Pearsall.

I want to thank you for coming here, for preparing your statements, and I want to thank you for the time you gave in the past 10 months or so in contributing to this task force report. To the extent that it is any consolation to you, I want you to know that it is my intention that this task force report not simply be filed and collect dust but that it be used as a good starting point from which to make legislative and other changes.

Mr. Pearsall, I do know Mr. Wirth wanted to be here. He probably had 10 other engagements.

I think, Mr. Casey, as chairman of this task force, that it would be most appropriate to have you begin your testimony first.

TESTIMONY OF WILLIAM J. CASEY, CHAIRMAN, SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL AND COUNSEL, ROGERS & WELLS, WASHINGTON, D.C.; ACCOMPANIED BY STANLEY GOLDER, PRESIDENT, FIRST CAPITAL CORP. OF CHICAGO, CHICAGO, ILL.; WILLIAM R. HAMBRECHT, PARTNER, HAMBRECHT & QUIST, SAN FRANCISCO, CALIF.; CHARLES L. LEA, JR., EXECUTIVE VICE PRESIDENT, NEW COURT SECURITIES CORP., NEW YORK, N.Y.; AND DUANE D. PEARSCALL, PRESIDENT, STATITROL CORP., LAKEWOOD, COLO.

Mr. Casey. Thank you, Mr. Chairman. It is a pleasure to appear here. It is particularly encouraging to have this new subcommittee describe itself as working on capital, investment and business opportunity. I think we are particularly encouraged by your attitude toward our report and your statement and dialog with Mr. Weaver about the idea of the SBA and this committee functioning in an advocacy role. The reason I say that is that SBA plays a very important role, but the funds it makes available to small businesses really are a trickle as compared to the huge public savings that are being inhibited from investing in new and expanding small businesses.

I have submitted a statement as you requested and I would merely like to, as you also requested, focus on what I consider to be our more significant recommendations.

[The prepared statement follows:]
Mr. Chairman, members of the Subcommittee on Capital, Investment and Business Opportunities of the Committee on Small Business of the House of Representatives.

I am pleased to have this opportunity to discuss with you the Report of the SBA Task Force on Venture and Equity Capital for Small Business. This Task Force was appointed in July of 1976 by Mitchell Kobelinski, then the SBA Administrator. Its membership represented a wide cross section of experience in the operation of small businesses, commercial banking, venture capital, the operation of Small Business Investment companies, investment banking, institutional investing, specialized financing and business research and education. It was able to enlist the advice and experience of officials from the SBA, the SEC, the Treasury, the Labor Department, the Internal Revenue Service and private financial institutions.

We concluded that, unless we keep risk capital flowing into new enterprises, our economic progress and competitiveness in world markets will erode and young people will be denied opportunity. It is alarming that, in America today, venture capital for new and small businesses has become almost invisible. In 1972, there were 418 firm underwritings for corporations with a net worth under $7 million; in 1975, there were only four. These 1972 offerings raised $918 million; the 1975 undertakings brought in $16 million. Over that same period of time, Regulation A offerings fell from $256 million to $49 million. While this catastrophic decline in the capital small companies raised in our public markets was occurring, the new money generated for all corporations in registered undertakings increased nearly fifty percent—from $28 billion to over $41 billion annually.

At the same time, professional venture capitalists have been increasingly staying away from start-ups and young businesses, using their funds instead to take positions in established companies. A survey of investments made by members of the National Venture Capital Association, an organization of professional venture capital investors, revealed that in 1975, only four percent of their investments were start-ups, and only two percent were first-round financings—a sharp decline from previous years. More and more of these firms seem to have established a policy of avoiding start-ups by requiring an earnings record for at least one year before committing their funds. Apparently, experience has taught these firms a clear lesson. They must be able to recycle their money to get a satisfactory return on their capital; the time lag and the serious difficulties in getting their money out of new businesses has pushed their funds toward more mature companies. We believe that this stagnation in small business financing arises from a set of general conditions which have developed in the American economy and from specific impediments which can be discerned in our tax structure, in the regulations governing the issuance and resale of securities.

The general characteristics can be summarized this way:

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.

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.

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 recommended the corporate tax rates be modified so that the first $100,000 of corporate taxable income should be taxed at lower rates.

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 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 recommended that investors in qualified small businesses should be permitted to defer the tax on capital gains if the proceeds of a profitable sale are re-invested 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.

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.
Small businessmen whose enterprises survive and thrive may find it necessary
to seek external financing by the sale of their securities to investors. 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 recent years 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, under-
writing do not take place. Without underwritings, there are no investments, and
the economy suffers.

Congress 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 effec-
tive 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 con-
ced for an imaginative effort to clear up the difficulties created by the attri-
tion of the statutory private offering exemption. However, this Rule will neces-
sarily be cumbersome, complicated and burdensome until Congress acts to restore
the original intent of the private offering exemption.

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 to-
wards companies with proven earning records. Furthermore, this leads to the
liquidation of investments through takeovers by large corporations instead of by
sales in the public securities markets.

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.

The Commission can and should speedily amend Rule 144 to provide that exist-
ing 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, whichever is higher, instead of whichever is lower. The
Commission's economics staff has undertaken what is, as far as I know, the first
empirical analysis of the need and justification for "protecting the market" by
the use of any quantitative restriction on secondary sales of unregistered securi-
ties. If this study concludes that required disclosure of the amount of shares to be
offered—combined with the self interest of the sellers in not breaking the mar-
ket—is all the protection the market needs or deserves, the quantitative limita-
tion should be further reduced or eliminated after some reasonably set holding
period. Protection of investors against uninformed or misinformed buying is an-
other matter which is substantially met by the requirement that the issuer shall
have made information about its performance publicly and currently available to
the same extent as other issuers having shares—registered or unregistered—
traded in the public securities markets.

Mr. Casey. Then general conclusion of the task force was that to
restore capital for small business and growth businesses, the tax im­
pediment is the primary obstacle. We have dissolved capital gains taxes
to a point where the risks, which are inherent in these investments, are
just increasingly less justified.

Mr. Kasten. Mr. Casey, the people in the back are having a difficult
time hearing you. They are all straining back there.

Mr. Casey. I will speak up.

The capital gains tax rate has been increased so as to lessen the tax
on the differential between the tax on the gain from a risk investment
and ordinary investment and earned income. This has become
the most fundamental impediment to taking the real risks involved in
a new venture.

So, one of our most important decisions was to recommend allow­
ing reinvestment of the gain on small business investment, with the
capital gains tax deferred. That would encourage risk investment and
would reestablish the incentive to take the risks required to provide
equity and venture money for small businesses. That is our major tax
recommendation for encouraging investment in small business. I have
another important tax recommendation which I will come to later on
when talking about small businesses that have to finance themselves.

The other major impediment is in the SEC rules and regulations.
The cost of registering is over $100,000 which is an automatic bar to
many worthwhile businesses. Underwriting costs will more than dou­
ble that for most small business offerings. These impediments have
grown. For about 20 or 25 years it was assumed that small businesses
could get together, 20 or 30 investors, pool their money to start or
finance a business without the requirement of registration. This
exemption over the years has been narrowed so that offerings involv­
ing as few as two or three people have been held to require
registration.

The SEC can and should speedily amend rule 144 to provide that
existing quantitative limitations apply for only a 3-month period
instead of 6 months, and that the limit be set at 1 percent of out­
standing shares or the average weekly volume, whichever is higher,
instead of whichever is lower.

The net effect of the existing requirement is that the investors who
are prevented from recycling their money are not likely to invest at
all. The effects of these regulations has seriously clogged the chan­
nels of venture capital. This not only has made it difficult to start
businesses and finance their growth, but it has created constraints on
competition because unnecessary regulations on the resale of stock in
these small businesses leads small companies to sell out to big com­
panies as the only way to expand and the only way to liquefy money
invested in their original stock.

Now, this is a complicated problem. I can only touch on it. It is a
problem that requires a great deal of attention in both the Congress
and the SEC.

I bear some responsibility for some of those regulations because I
was Chairman of the SEC when they were inaugurated. They were
put forth as experimental. They have worked well to some extent, and I am pleased to see the Commission is asking for their reconsideration.

I was so stimulated by the task force's consideration of this problem that I did a law review article on these SEC restrictions. I have a couple of copies here which may be useful to the subcommittee.

Now, the final point I would like to touch on is that as we analyze the problem it becomes clear that there are two distinct categories of small businesses. First, those which will qualify for public investors, which will need public investing to get the kind of capital that their prospects will justify. Those are the companies by and large which suffer from a lack of access to the public market and from the impediments which the ERISA has created on the investment of institutional funds.

If ERISA did not create the fear, the fear of liability, and you really cannot blame the administrators of ERISA, Congressman Luken, because I think, on the whole, they have been quite responsive in trying to ease these concerns. The problem is nobody knows what the liability is and nobody will find out until the court speaks. So, there is quite a fear to invest pension money in anything except for the largest and most established—and only Congress can reduce that very soon.

The other category is the business which never gets big enough to get outside financing, where they go to the family to put capital together, and to friends and neighbors, in localities all over America. Even these companies now have to register with the SEC to provide absolute assurance that an investor cannot change his mind and pull his money back. But fundamentally these businesses will have to grow on their internal forces of financing.

I think as the cost and capital requirement of expanding businesses and of starting a business has increased with inflation, it is appropriate that consideration be given to increasing the surtax exemption. Increasing that portion of the earnings of a corporation which gets the benefit of a lower tax break. If $25,000 where the right amount 20 years ago it is probably $100,000, today.

The second thing which would promote the preservation of internal flows of funds is SBIC financing. The more flexibility, the more investment can occur.

Now, I have not made any comment with reference to SBA regulations. You asked me to express any of the task force solutions which I don't totally endorse. I must say I was pleased to see the Administrator express his reservation about subsidies. I have the same reservation about that.

One final comment. Interest was expressed in how you increased the use and the investment that private banks, the private banks system, will take in small business financing. I have some experience in that, for almost 2 years I served as Chairman of the Export-Import Bank. We did succeed in increasing the amount, the portion of export money that the commercial banks assumed in those transactions. We did it by a relatively simple process. We increased the price they had to pay for our guarantee from one-half percent a year to 1 percent a year and many assumed the risks themselves. Now, SBA charges over 1 percent
for the full guarantee of a 7-year loan. Eximbank charges a reasonable fee, one close to the market price. One percent over 7 years is a give-away. So, everybody is going to want the guarantee.

That is all I have to say, Mr. Chairman.

Mr. LaFalce. I have grave problems with that last one, but in keeping with what I said earlier we will have the testimony of all the panelists before we have any questions.

Mr. Lea?

Mr. Lea. Do you have a copy of my testimony?

Mr. LaFalce. I believe I do.

Mr. Lea. I will just read parts of the statement.

I think that is a good report, this SBA task force report. I think it is a good report because it hits on my experience, which I have been in the business for—in the neighborhood of 25 years. It hits where we all live today.

In general, I endorse the entire recommendation package of the task force report. There were a great many other recommendations that we could have included but this final report represents a very trim list. Nevertheless, I would like to particularly endorse several of these specific recommendations. On the basis of this trim list I would particularly like to endorse several recommendations.

The report has reflected one, and this is particularly the "rollover" recommendation where you provide capital gains taxes that is reinvested in small business. That is a very important provision that we see that would go a long way to bring an increased incentive for investment in smaller businesses.

I also believe that there is a lot to be said for the underwriting tax reserve provision. This would be most useful.

Under the ERISA provisions, the basket clause of 5 percent and the promotion of professionally managed pools of capital investing in the marketable securities of emerging companies strikes me as very timely. I look at all the SEC recommendations as necessary and minimum steps to correct an increasingly burdensome problem.

We reproduced a chart in this report which I have included in my statement.* This chart takes you through each individual stage of investment from the time it starts out with an idea right through to the time where you get a $100 million company that is going into the marketplace on a day-to-day basis.

Ten years ago it was that a few of us thought that with $200,000 or $300,000 you could probably get there, from 0 to $100 million in a period of 10 years. Of course, that time has long gone. Right now what this chart is telling is that it takes between $5,000 up to $1 million and 5 years of thought and labor to develop the idea or basis of a company that can have significant economic impact. Then it might require $2.5 million and 3 to 6 years to organize and commercialize the production of the company to the point that it can break even on an annual basis. It may take between $4 million and $10 million of additional capital before the company can be considered to have reached the status required for a normal public offering.

*Chart appears on p. 25.
In suggesting this there is an authorized requirement in the neighborhood of $7 million to $7½ million and a time span of a minimum of 7 years to bring a company to a point that it might be truly on its own financially, having normal recourse to lending institutions and public stock markets. That is the kind of proposal that lands on my desk every day.

Now, this is obviously a very long time to tie up capital without significant return. It is only at this point where we start dealing with rule 144 where we design a fair share starting process of trying to unlock it. So, if you own 20 percent of a company you can be, in theory, up to 10 years liquidating your position, and the 144, if that was the only access you had.

Now, management of these new entries is also very difficult, and as there are in our particular investments, there are great casualties along the way. A lot of these we invest in just never make it. Yet it is the process described on this chart that holds the answer to increasing employment and tax revenue in the United States in the years ahead. We must find a way to encourage this process. Otherwise we are doomed to stagnation, inflation, and ultimately disorder.

Heretofore, particularly in the latter 1950's and in the 1960's we enjoyed financial markets conducive to this kind of activity. First, an entrepreneur with an economically sound idea could secure competent backing on favorable terms from the venture capital community. The venture capitalist could in turn secure credit for his companies from both banks and insurance companies if projected cash flow appeared reasonable. These institutions could lend with some frequency and assurance to small companies so long as there was a reasonable appetite for new issues in the public stock market. Of course, this whole cycle of financial events has broken down with the collapse of the securities market for smaller companies and the withdrawal of the public investor. This, of course, has thrown a large part of the burden of carrying these emerging companies back on the venture capital community. To make my point, starting new enterprises today is not a very compelling business.

Today the venture capital community is committing its funds very slowly to private transactions knowing that these funds will not become available again for a very long time. Liquidity of portfolio—always an important consideration—is doubly so today because in our business you must always remember when the people you have backed have no alternative source for new money for payroll or for plant, your door must be kept open.

Thank you for your courtesy and your attention. I will try to answer any question you have.

That is my testimony.

[The prepared statement of Charles L. Lea, Jr., follows:]

PREPARED STATEMENT OF CHARLES L. LEA, JR., EXECUTIVE VICE PRESIDENT, NEW COURT SECURITIES CORP., NEW YORK, N.Y.

Mr. Chairman, I have a statement to make to this Subcommittee concerning the Report of the SBA Task Force on Venture and Equity Capital for Small Business.

First off, I am happy to be here and to be given this opportunity to discuss this report. In my opinion this is a very good report that sets forth a series of recommendations that could have a significant and powerfully beneficial effect on the
economic well being of this country. This may seem a self-serving statement from a contributor to the subject report and from one who earns his living from the field under review but these are views honestly held.

In general, I endorse the entire recommendation package of the Task Force Report. There were a great many other recommendations that we would have included but this final report represents a very trim list. Nevertheless, I would like to particularly endorse several of these specific recommendations. Under the tax recommendations the so called "rollover" provision of qualified business investments and the underwriters tax reserve provision appear most useful. Under the ERISA provisions, the basket clause of 5 percent and the promotion of professionally managed pools of capital investing in the marketable securities of emerging companies strikes me as very timely. I look at all the SEC recommendations as necessary and minimum steps to correct an increasingly burdensome problem.

Let me try to be useful to this inquiry by focusing your attention to the chart on page five of this report. The chart is entitled:

**LIFE CYCLE OF A NEW ENTERPRISE MODEL OF A HIGH-TECHNOLOGY PRODUCT COMPANY 1975-76 FINANCIAL MARKET CONDITIONS**

What we are saying here is that a normal investment situation takes between $5,000 to $1,000,000 and up to five years to develop the basis for a new company that may have significant economic impact. It may require another $2.5 million and three to six years to organize and commercialize the product and bring the company to the point that it can break even on an annual basis; and it will probably take between $4 to $10 million of additional capital before this company can be considered to have reached the status required for a normal public offering. In sum this is an outside capital requirement exclusive of retained earnings of $7-$13 million and a time span of a minimum of seven years to bring a company to a point that it may be said to be truly on its own financially, having normal recourse to lending institutions and public markets for its capital requirements. This is obviously a very long time to tie up capital without significant return. The management of these new enterprises is also very difficult and there are many casualties along the way. Yet it is the process described on this chart that holds the answer to increasing employment and tax revenue in the United States in the years ahead. We must find a way to encourage this process. Otherwise we are doomed to stagnation, inflation, and ultimately disorder.

Heretofore, particularly in the latter 1950's and in the 1960's we enjoyed financial markets conducive to this kind of activity. First, an entrepreneur with an economically sound idea could secure competent backing on favorable terms from the venture capital community. The venture capitalist could in turn secure credit for his companies from both banks and insurance companies if projected cash flow appeared reasonable. These institutions could lend with some frequency and assurance to small companies so long as there was a reasonable appetite for new issues in the public stock market. Of course, this whole cycle of financial events has broken down with the collapse of the securities market for smaller companies and the withdrawal of the public investor. This, of course, has thrown a large part of the burden of carrying these emerging companies back on the venture capital community. To make my point, starting new enterprises today is not a very compelling business.

Today the venture capital community is committing its funds very slowly to private transactions knowing that these funds will not become available again for a very long time. Liquidity of portfolio—always an important consideration—is doubly so today because in our business you must always remember when the people you have backed have no alternative source for new money for payroll or for plant, your door must be kept open.

Thank you for your courtesy and your attention. I will try to answer any question you have.
Mr. LA Falce. Thank you very much.

Mr. Gold er?

Mr. Golder. Thank you. I am delighted to be here, and also to be part of this task force which, I might add, is a very hard-working group. You have my prepared remarks and I will try not to read them, but I would like to make a few comments.

I alluded in my remarks to the inadvertent adverse legislation on small business, and I was delighted to hear Mr. Weaver make his comment on dividends. I will comment also on ERISA; that is, what I might call problems of the spilloff.

I agree with Mr. Weaver. Dividend integration creates capital but I don't think it is going to help the small business sector.

To be specific on areas, I certainly concur generally with the report, as Mr. Lea did, and I think the SBIC program has been a good program. It has paid good dividends to the Government. I also feel that the program has been more limited than had hoped for the reasons for which are touched on by the task force report. I feel that a subsidy of a portion of the leverage can be a useful tool to move money into equity investment. In the present regulations there is no question that good economics force a manager to collect interest because he has to pay interest, and if he doesn't pay it the SBA comes after him just like anyone else. So, the economics just force the debt-oriented investment philosophy.

So, as one form of encouragement I do think that a subsidy of a portion of the interest could be helpful. I also think—as was already mentioned, that the tax laws clearly favor debt-type financing because of the ability to create reserves on loans but not on equity. Yet, when you are taking a high risk—a higher risk than you would in a loan, at least in a balance sheet sense, you are still not able to set up a reserve that is deductible for tax purposes. I think these are contradictory in practical economics and in intent.

The third SBIC point which I would like to make is the need for an increase in the size standards. I just cannot emphasize, enough, the need for this. They were set in the late 1950's and although increased recently, a large segment of the small or medium industry is in a "no man's" land today, as Mr. Lea indicated. They are too large for the SBIC and too small to have access to other sources.

I am delighted that the SBA and Mr. Weaver are looking at these proposals. I think these are the factors that provide more jobs, and more taxes. We will get great benefits from having a size standard increase.

Also, as Mr. Lea said, there is going to be some redundancy with this testimony. I think the liquidity for profitable investment is a very, very key area. The SEC problems of rule 144 are real. When we are wrong, we take our losses and that is the risk we are willing to accept. But if we are right, we want to be able to achieve our reward. This has become increasingly difficult due to the cost of registration and due to the restrictions of the SEC.

Again, in the case of ERISA I think it was an inadvertent effect but a very important effect.

The institutions do control such great percentages of the assets that if you eliminate them from the market it is going to be very difficult
for Mr. Hambrecht to get them into the marketplace. Mr. Hambrecht does a good job in a different market.

I think in talking to some investment managers that they clearly would like to invest but as Mr. Casey said, they are afraid of the unknown. So, I strongly endorse the proposed changes in SEC and ERISA regulations.

Another area that was touched on in the task force report that no one has mentioned is the question of value accounting. The SEC and the accounting bodies have required, or increasingly require, venture capital companies and owners to go to value accounting. This can be very difficult for those of us who are owned by public companies. Depending on how the interpretation of these rules go, we might have to review or reevaluate the desirability of making these kinds of risk investments if we are going to have extreme fluctuations in the profit-loss account.

Lastly, I would like to address something that is not in my testimony that happened to me yesterday. I think it is worth telling. I was in Boston with a company we helped start 7 years ago. It was sold to a larger company. And after the formalities we were sitting around reflecting. Two of the entrepreneurs were there and I said, "Well, would you do it again?" They said, "I don't think so." I said, "Why?" I wish I would have had a recording there. The answer: "There is no incentive to do it. We took lower salaries. We worked 80 hours a week. We had a capital gains tax of 25 percent when we started. Today we have a capital gains tax of 50 percent." One of the men moved out of Massachusetts into New Hampshire because of tax problems. He said, "Why do it? I could make more in salary in industry. Why take the risk?"

That, to me, was so telling and so reflective and was unsolicited. Then I told them where I was coming today and they asked that I reflect their attitude. The reward for taking risk is being removed from the economic system.

That would conclude any formal remarks I have.

[The prepared statement of Mr. Golder follows:]

PREPARED STATEMENT OF STANLEY C. GOLDER, PRESIDENT, FIRST CAPITAL CORPORATION OF CHICAGO

My name is Stanley Golder, and I am President of First Capital Corporation, a small business investment company, and its affiliate, First Chicago Investment Corporation, which is an investment company organized under the provisions of the Bank Holding Company Act. During 1975-76, I was Chairman of The National Advisory Council on Small Business Investment Companies to the Small Business Administration and am currently an officer of The National Association of Small Business Investment Companies, and The National Venture Capital Association. I was pleased to be a member and participant in the SBA Task Force on Venture and Equity Capital which report was published in January, 1977.

First, let me say that I support the conclusions of the Task Force, and think that the recommendations therein, if completely accomplished, could significantly enhance the ability of smaller and medium-size companies to have access to capital.

It is clear that our economic structure has provided us with more jobs and more wealth for more people than any other in the world. However, we have entered an age of consumerism in which Congress and various regulatory bodies have enacted laws and regulations intended to provide protections of many kinds. The Task Force report clearly shows that growth of small business is important
to employment, taxes and innovations in technology. Too often the unintentional adverse effect of legislation and regulation on the small business environment may be equivalent to "throwing out the baby with the bath water."

As requested in your invitation to appear before your Committee I will try to limit my remarks to the specific recommendations of the Task Force, and comments on those items which I consider the most significant.

As the President of an SBIC and an investment company, my interests fall particularly toward those suggestions in the Task Force report which would apply to companies seeking public capital or companies which in the future might be seeking public capital. Therefore, my first comments would be on the section of the report dealing with the SBIC program.

The SBIC program has paid good dividends to the Government in the form of new jobs and increased taxes. However, the present form of the program has been more limited than some had hoped, for reasons which the Task Force report touches on. At the present time Government leverage is provided on a 4 to 1 basis at a full market rate of interest. The SBA is charged with collecting interest on a semi-annual basis and if an SBIC does not earn this interest it clearly cannot pay it. Therefore, SBIC investment has tended toward "debt financing" rather than equity financing as originally intended. If it is desirable to have more investments in the form of equity which generally does not have a current income feature, the interest charge has to be reduced or eliminated on some portion of the SBIC leverage, as suggested in the report.

In this same regard, the tax laws also favor an SBIC investing in debt-type financings, as the tax laws do not permit a deduction from income for loss reserves on the equity portion of the investments. Obviously, there is a contradiction between the intent of the law and practical economics.

Third, still dealing with SBICs, as indicated in the chart on page 5 of the report, companies have to have a revenue level of $25 million or more before they can have access to all sources of finance, public, markets, insurance companies, etc. The SBA size standards were basically set in the late 1950s and, although increased recently in one category, still, in my opinion, leave a large segment of medium-size industry in no man's land where they are too large for SBIC standards and too small to have complete access to other financial sources. It is this portion of the industry, as the report indicates, that tends to provide more jobs and more revenue increases for the economy. Substantial increase in the size standards for SBIC investments would fill this void.

The next area that is of importance to me is the question of liquidity for profitable investments. We, in this industry, whether SBIC or venture capitalists, are in the business of taking risks for which we seek reward. In some cases we are wrong and we take losses which we are willing to accept, if we can reasonably expect to achieve a reward on some of our investments. As shown on Page 13 of the Task Force Report, going public for young companies is almost impossible. It seems clear that the present rules of ERISA have created a concern in the minds of funds managers about buying stocks in over-the-counter and younger companies. This would appear to have a significant influence in reducing the appetite of investment bankers to underwrite younger companies as this tremendous institutional market is basically unavailable. Therefore, I support the proposed changes in ERISA legislation.

Even when a public market can be achieved we find that the very narrow limits set on the use of Rule 144 by the SEC tends to make it more difficult for venture capital investors and SBICs to sell their stocks in successful companies. I strongly endorse the suggested changes in this Rule.

As I indicated earlier, venture capital investments are often unintentionally affected by Congressional and regulatory action such as I mentioned in ERISA. Another unintentional adverse effect could result from the requirement by the SEC and accounting bodies that the illiquid securities of small companies should be valued at fair value. This is a highly subjective process which could cause problems for institutional and venture capital investors. This requirement to go to strict "value accounting" and its uncontrollable effect on profit and loss, could cause our institution and others to reevaluate the viability of making these investments.

There are many other areas, of course, which I could comment on, but I'm sure your other witnesses, both today and next week, will adequately cover them.

I thank you for inviting me, and certainly would be glad to answer any questions.
Mr. LaFalce. Before we go to the next witness, I have been a little remiss. I think, for the purpose of the record, it would be very good if each of you very briefly indicated your background and experience, which eminently qualified you to be members of the task force and which really makes your opinion of respect.

Mr. Casey.

Mr. Casey. I have been a venture capitalist and a lawyer and chairman of the SEC and Under Secretary of State for economics and Chairman of the Import-Export Bank. I am now a lawyer. I might be a venture capitalist but I am a little nervous.

Mr. Lea. Well, I have been, since 1953, a venture capitalist. I am executive vice president of the New Court Securities and New Court Securities manages probably one of the largest private pools of capital in the country.

Mr. Golder. Since 1970 I have been president of First Capital Corp. of Chicago which is in SBIC and its affiliate which is an investment company organized under the Bank Holding Company Act. We are both subsidiaries of First Chicago Corp. and we are one of the largest bank-related investment companies.

I have also been chairman of the National Advisory Council on Small Business Investment Companies to the SBA until the beginning of this year. I am an officer of the National Venture Association and of the National Association of Small Business Investment Companies.

Mr. LaFalce. Mr. Hambrecht, before you give your testimony, your background, please.

Mr. Hambrecht. I have been on the business scene since 1958. My partner and I formed an investment banking corporation on the west coast 9 years ago to provide an investment bank service to the small manufacturing companies. During the past 9 years we have managed and placed 35 venture, private financing. totaling $47 million and have managed 36 public offerings for emerging companies totaling $141 million. Because of this background my particular role with the task force was to focus on the role of public financing for emerging companies. I think Mr. Lea and Mr. Golder very clearly spelled out the interconnections between venture capital and the public market. I think it is safe to say that without the eventual liquid ventures capital will eventually dry up or companies will go and solicit and get venture capital and it will sooner or later be forwarded in selling out or merging upstream to give the liquid stock to their investors.

I think, Congressman, you did cite the figures in our report about the precipitous decline in activities for companies of under $5 million net worth in the public market. I would like to amplify on that.

During this period of time that we talk about and showed in the report, the total public new money raised in total public offerings increased about 50 percent. The number went roughly from $28 billion in 1969 to over $41 billion in 1975. So, I think it is very clear to us that the public market cut was being designed so the small business companies won't, though it was getting increasingly active.

In the report and in our deliberations we talked a great deal about the reason why this happened. I think, obviously, you cannot ignore the market cycles nor the abuse of the market in the 1950's and the 1960's. I think the SEC has had hearings on this hot issue. I think there have
been some very good new rules promulgated. There have been new achievements. I think there are now new and good safeguards against a return of new abuses in the new issue market. But I think it would be a dramatic mistake to say, "Let's just wait for the next market cycle, then the market cycle will change."

I think the committee and the task force really came to the conclusion that there is some basic structural change taking place in the money market that has basically caused this precipitous decline for underwriting for small companies.

We talked to companies and asked them why they don't invest. They say, "I just don't want to." They put it in savings. Any number you look at now, 70 percent of the New York Stock Exchange trade activities is for the —

Mr. LAFALCE. I am really frightened by that.

Mr. HAMBRECHT. Well, the report also goes on to say pension funds have tripled since 1962 and the estimates by 1985 or not more than half of all available equity for investment will be in the hands of pension managers and they are inherently more conservative. I think ERISA has even increased that bias toward conservatism. I think all the bias in the world is not going to change the basic philosophy from individuals to professionals.

Mr. LAFALCE. You are a fiscal conservative against fiscal conservatism.

Mr. HAMBRECHT. The second point is the conservation process which has been going on in the securities business. Underwriters are sold not because they are marketed by a system. In 1968 the brokers' commission was adjusted and has been phased out through a period of 1975. During that period the number of registered receipts, registered with the National Association of Security Dealers, has remained relatively stable. We are about the same total number of sales members. But we have 35 percent fewer brokers dealing and it is precisely the small broker whom the small company used to call on to provide underwriting and market advice. This man is being squeezed out of business. The decision making, the trade activities, the underwriting activities, the reserve activities, all tend to flow back when they are acquired by those larger firms and that just increases the problems for small companies in California, Massachusetts, or wherever they need the money to get the attention of the large New York firms.

To touch briefly on the recommendations, I feel there were three that are particularly close to my point of view and I think are very important. First of all is ERISA. It has been mentioned by every panelist here. I think it is important to focus on the practical aspects of ERISA. We have some testimony from the, or hearings from the Treasury, that say it is not nearly as bad as that. Practical results of ERISA is that the major institutions will not invest in small companies. We have some testimony from the, or hearings from the Treasury, that say it is not nearly as bad as that. Practical results of ERISA is that the major institutions will not invest in small companies. I think you can document that. You can find institutions that now have policies that say, we will only invest in the top two capitalizations or top 400. They do not understand ERISA. Therefore, they are defensive. I think the only practical approach is the basket clause, a clause that specifically spells out, "You are allowed to put 2 percent, 3 percent, 5 percent, or whatever, in funds mandated for small company investing."
The best approach that I have seen is Stanford University. The trustees at Stanford have formed a policy for their money managers to follow, that essentially gives them a mandate to invest over a spectrum of American business that is representative of American business as it is today. In other words, they are saying, if x percent of our business activities is generated in large companies we should invest x percent and our other moneys should be spread over the entire spectrum of sizes.

The second suggestion I think is imperative is, if we are going to a return of public markets the solution is to simplify and cheapen the registration process to go public. Mr. Casey spells out the costs. It just does not work because the thing to remember is that the company has to commit that money before they know the offering is going to be successful. So, he is gambling $100,000 before he knows he is going to get a dime back. Companies of $5 million in sales are not going to gamble 25 percent to try and go public.

The third thing we touched on in the report: I think it is obvious that we cannot go back to fixed commission rates. I do not want to. The investors' bank system is competitive. It ought to be competitive, but I do think there ought to be some incentive to be responsible to the marketing and to underwriting activities. I think, again, you can clearly prove this is inherently critical. You have good years and you have bad years. I think this is an activity that could very well justify a loss reserve, a reserve against future losses.

Mr. LaFalce. I am afraid those bells are going to ring shortly. I do want to move on.

Mr. Pearsall. It is a privilege to be here today. You have my written statement.

[Mr. Pearsall's prepared statement follows:]

PREPARED STATEMENT OF DUANE D. PEARSALL, PRESIDENT, STATITROL DIVISION, EMERSON ELECTRIC CO., LAKEWOOD, COLO.

My name is Duane D. Pearsall. I am President of the Statitrol Division, Emerson Electric Co., Lakewood, Colo. Until our merger with Emerson Electric in March of this year, Statitrol was an independent manufacturer of home smoke alarms and commercial smoke detectors. We were a small business, now 13 years old, and because of our success, I was named by the Small Business Administration as Small Business Person of the Year for 1976. During the past year, I was appointed by the Administrator, Mr. Mitchell Kobelinski, to serve on the Task Force on Venture and Equity Capital.

This is my first appearance before a House Committee. Having made over forty speeches in this past year on behalf of small business, I am encouraged and gratified that the Task Force Report has reached the attention of this Committee. I sincerely hope the Committee will give careful consideration to each of the nineteen recommendations in order to halt the precipitous decline in access to capital now experienced by small and intermediate size businesses.

It is my understanding that this Committee will be hearing testimony from the Honorable William J. Casey, Chairman of the SBA Task Force on Venture and Equity Capital. Mr. Casey should be commended for his leadership and personal accomplishment in managing to condense a monumental amount of data into a useful document.

Therefore, I will confine my remarks to a description of the development of our Company which typifies a national problem, resulting in the erosion of the numbers of intermediate sized businesses in the United States.

Our Company was formed in 1963 to manufacture a static control device intended to reduce electrostatic charges in photographic dark rooms. Using a homemade instrument to measure concentration of free ions, we accidentally...
discovered its sensitivity to smoke. This subsequently led to our development of a commercial ionization smoke detector. After 3 years of hand-to-mouth financing of the development of technical product, always on the verge of bankruptcy, we convinced a small business investment company (SBIC), in 1966, to invest $250,000, 7-year term, 8 percent note with warrants to purchase options on 49 percent of our outstanding stock. I would remind the Committee that in 1966, an interest rate of 8 percent was considered exorbitant. Because of their sound financial advice and assistance, our relationships with SBIC, Central Investment Corporation of Denver, have been excellent. It proved to be a wise investment for both parties.

Three years later in 1969, with a gradually growing sales volume, we were able to build our first plant for $92,000, with the help of a 40 percent SBA direct loan. These special SBA funds involved an extremely complicated procedure which required that we hire an attorney at a cost of $2,000 to process the paper work. Under this program, involving a local development company program, we ended up with five mortgages on our building, one of which was issued to ourselves. This loan was subsequently replaced with a 90 percent SBA guarantee loan for a second plant expansion.

In 1971, we introduced a battery powered home smoke alarm. In 1972, almost single handedly, with the help of a consultant, we influenced the International Conference of Building Officials, a national model building core organization, to require a home smoke alarm in new construction of one- and two-family residences and each apartment living unit. Its acceptance was followed by other model building codes, adopted by municipalities throughout the United States. In 1976 there will be over eight million such devices installed in homes with a potential savings in lives measured in the hundreds.

In late 1975, the first major U.S. corporation introduced a competitive device on national television. Although our own Company has grown dramatically, our market share today is less than 10 percent. To meet national competition, it is necessary not only to add research and development staff and facilities, but also to progressively automate our production.

By mid 1976, two of our major independent competitors, who were small businesses, became acquisitions of large corporations. We became visible in the market place as the largest independent smoke alarm manufacturer. However, we began to experience a rapidly decreasing share of the market.

At this point, it became obvious that we could not generate capital through internal sources in sufficient quantities to meet national competition. In reviewing alternatives, our first choice was to become a public corporation. However, because of the unintended effects of ERISA (Employees' Retirement Income Security Act of 1974) combined with the effects of SEC Rule 144, together with the anticipated costs of underwriting, we could not expect nor predict an acceptable stock offering. As further consideration, our major stockholder would not be able to relieve equity due to the constraints of Rule 144.

We considered starting an ESOT (Employees' Stock Option Trust), but after careful scrutiny, because it represents a stock sale to employees, it would not represent a sufficient multiple on earnings to justify and would injure future possibilities of a sale. Historically, ESOT's have been valuable as a low-multiple bail-out method for a low growth company. Again, this alternative was considered unacceptable.

Other alternatives were reviewed, such as a leveraged asset method, the purchase of an existing but inactive public company, etc.

The final conclusion, and the only reasonable alternative, was to seek a merger partner. This resulted in the acquisition of Statitrol by Emerson Electric Co., St. Louis, Mo., effective March 16, 1977. We are very pleased with our new partner and have a renewed confidence to approach the market place from a position of strength and with a new perspective.

The purpose of this testimony is that our experience demonstrates very clearly that the unintended effects of legislation, such as ERISA, combined with constraints of SEC, compounded by the inability to generate capital for growth, internally, is forcing the elimination of most intermediate sized, successful companies in the United States. At the same time these effects contribute to faster growth of major corporations, tending to institutionalize the large manufacturing sector of our economy.
SUPPLEMENTAL REMARKS

In my talks to over 3,000 small businessmen in the past year, major concerns of government intrusion involve the burden of government regulations. ERISA, for example, has created exorbitant costs in maintaining pension or profit sharing plans. The combination of outside professional help in the form of legal and accounting services, together with the enormous paper work burden necessary to maintain their plans, smaller businesses, under 25 people, find it more practical to cancel. Minimum annual costs to maintain the smallest plan are estimated at $2,000 to $2,500. Recently, insurance firms have started marketing standard format plans, reducing the cost somewhat, but the net effect is still prohibitive. Statitrol Corporation, with an average of 650 employees, expended an estimated $13,000 in costs to maintain the simplest, most liberal form of profit sharing plan possible in 1976. Since most plans require these costs to be deducted from annual contributions, the burden of maintenance is on the employee. We find, ironically, that a typical employee is sacrificing his retirement income in order to comply with government regulations. In addition, of course, his taxes support the agency.

Another major concern of small business is the almost insurmountable problem of product liability. Many small businesses feel they are living on borrowed time because they are walking in the shadow of a product liability suit which guarantees, in most cases, absolute disaster.

My final point involves a recommendation for new legislation for the very small, or "mini" business. Since the definition of small business is necessarily complicated and encompasses some fair sized companies, there seems to be a need to identify the really small business, such as under 10 employees, or with gross receipts under $500,000.

Recommendation—new legislation which will allow a precisely defined "mini" business to be exempt from regulations of independent agencies such as OSHA, EPA, ERISA, etc. Such a bill might well restore confidence among several small business owners.

It has been a privilege and an honor to appear before you today. I hope I can always be considered as a spokesman for small business. As a body, we have been the victims of unintended effects of legislation. The resultant negative effects, together with the increasing burden of government paper work, have undermined the very foundation of our small business sector and, in so doing, has already seriously eroded the foundation of our free enterprise system.

Thank you very much.

Mr. PEARSALL. I want to leave one impression. First, my background is 22 years as a small businessman. The first 18 years I was a very, very small businessman with less than 10 employees. In the past 4 years we have been very successful. As a result, last year I received the SBA award as the National Small Business Person of the Year. Receiving that award allowed my name to be appointed to this task force. I have thus been cloaked in some wisdom that is not justified. It was not there before the award. It is not there now. But, in the past year I have had the opportunity to speak to probably 3,000 small business persons either in service clubs or chambers of commerce, et cetera.

I served on the board of two chambers of commerce and I am on the Executive Committee of the Council of Small Business of the U.S. Chamber—which is the new Council of Small Business—which is out to improve the image of the U.S. Chamber in Washington.

My purpose in being on this committee has served an additional purpose. As we began to study the venture capital problem it became clear that our company proved to be an example of what was happening to small businesses, or more accurately, the intermediate-sized business sector in the United States. I just want to call your attention to the period of time where it became critical that we make a decision on how to secure additional capital financing. It is very fresh in my mind
because, as of March 1977, we became a part of a large corporation. My first choice was not to become part of big business. I would much prefer to have been a public company. I have had the counsel of the members of this committee, including the chairman, who tried to help. Bill Hambrecht also tried to help me.

Unfortunately, the public market would not produce the return that our major stockholder would require. Our major stockholder was an SBIC.

I would like to emphasize the management assistance aspect of SBA that President Carter discussed with Mr. Weaver. I feel the SBIC in our case provided the business management assistance to our company. But, the final issue that bothers me is a deep concern. Any company that is innovative or growing, needs money for continued growth to meet competition.

In my case, as a successful company we created competition with major corporations. We are now only a small part of a $200 million market which we really almost singlehandedly generated. To get that capital we have had to go to big business. We investigated the ESOP Congressman Marriott alluded to. Our reasons against the ESOP was, that historically it has been used as a low multiple bail out for low-growth companies. It does not provide the return to its major investors an SBIC that would be required. We looked at all alternatives, for instance, a leverage method where it required a high capital-intensive operation to be effective.

We have had the best advice of any company in our position and the alternatives from which we had to choose forced us to become part of big business. I am not apologizing for that. Frankly, I have become a very wealthy man as a result of it, but it was not my first choice, and I do not think it is inconsistent with any successful entrepreneur.

I am pleased that the committee has taken this task force report seriously. I do not want to digress from the report more than is absolutely necessary. My priorities relative to the report are, No. 1, the reinvestment capability of investors in small businesses to reinvest in another small business with the privilege of deferred capital gains tax treatment.

The second point, and I would like to emphasize, is that three of the members of this committee represented very small businesses. We had a lot of discussion about SEC requirements and public offerings but there were three of us that were concerned with the very small businesses. The only significant help that can be made to that segment is to change the surtax exemption. We recommended simply doubling the present—to $100,000. I think that is very important, and I do not want it to be overlooked. It may be tough to get, but it is extremely important.

The third problem is ERISA. From the standpoint that it restricts investment in small businesses in the public market and is a major factor in preventing a reasonable price or reasonable liquidity potential on sale to the public market.

I must also comment on what Congressman Lukan and Congressman Marriott referred to and that is the paperwork burden of ERISA. It is horrible. Just this week, and that is why it is so prominent, we
changed our only program for the third time. When I say changed our program I mean a whole new legal document because of the subsequent interpretations of ERISA. It is a monster. It has caused the elimination of more pension profit-sharing plans than at any other time in our history. I have not found a small business who will acknowledge an annual cost of less than $2,000 to $2,500 a year just to handle the paperwork and reporting requirements. The alternative is to cancel the program. That is what is happening. I think ERISA is a growing monster. Each change we have made in our plans has reduced the benefits to our employees.

It now prevents us from paying off a profit-sharing account in less than 1 year. This has to do with an interpretation of how forfeitures must be applied subsequent to the termination of an employee, should the employee come back to work for you. It is a complicated, unnecessary set of interpretations and regulations in my view. I apologize for the digression.

I want to make one other point. There is talk of moving out of the double dip tax on dividends. I disagree with taxes on dividends. It is morally wrong. I would call attention to pursuing the task force recommendations as they are now very important. When the dividend tax is removed it further draws capital away from small business in a gross manner. I have a major frustration in this area.

I appreciate the opportunity to be here this morning.

Mr. LAFALCE. Thank you very much.

INTERVENING TESTIMONY BY SIX TASK FORCE PANELISTS

Mr. LAFALCE. Mr. Weaver, this may be a little bit unusual. I was delighted that you remained for the presentation of all the panelists. I wonder if I could ask you to become a member of this panel?

Mr. WEAVER. I would be delighted.

Mr. LAFALCE. Thank you very very much.

While I might address a question to one particular individual, I would ask any individual to comment. While I may be the official questioner, I would rather that this now take the format of a discussion among the seven of us. I think it might be much more fruitful that way. I will be the moderator, if you will, of this discussion.

To start it off, Mr. Hambrecht, you indicated that the figures in 1969 from public financing were $21 billion. Is that correct?

Mr. HAMBRECHT. That is correct.

Mr. LAFALCE. What portion was for national public financing and what percent was to raise equity capital from your company? I think that major corporations were in need of additional capital and very often with a tight money market had to choose the public offering route.

Mr. HAMBRECHT. I do not have those numbers with me. They are available. I can tell you a gut feeling that there were very few official offerings either for small or large groups.

Mr. CASEY. It would be a very small proportion.

Mr. HAMBRECHT. I think we are talking about $40 billion. It is only 1 percent of national public offerings.

Mr. LAFALCE. So, it cuts across the board not only for small businesses but also for large businesses, too.
Mr. Hambrecht. Except I think the point is that most of the larger companies who have a need to or wanted to go public are there already.

Mr. LaFalce. I am concerned that this report does not focus in enough on the truly small. Mr. Pearsall, in your testimony you called for distinguishing small businesses and minibusinesses or "small small" businesses. That is why I was especially interested in your priority to increase the surtax exemption and perhaps the recommendation which would best affect the truly small businessman. I think that would truly address this. Is there any other way of addressing this equity in venture capital problem other than this?

Mr. Pearsall. I think the SBA can play a major role through their VISTA and SCORE programs and building a management expertise because management is a major characteristic but there are many small businesses that are not growth oriented, that is the day-to-day business and the small one- and two-man business. I think internal generation of capital is the only hope for them.

Mr. Casey. They cannot get it from the public. There are only two ways you can deal with it: One is for Government to get it, and the other is to let the Government let them keep it.

Mr. LaFalce. That is if they have no access other than through the Government or themselves.

Mr. Golden. I think it is important, Mr. Chairman—that you understand that there was a lot of discussion and I think we were all very interested. But people in this position often do not want outside investors and that was very clearly brought out. This is the very small businesses we are talking about. There were those people represented at a panel group. They really do not seek outside investors so the internal generation lets them keep more. Let them have faster depreciation, lower tax rates. It seems to be the only conclusion.

Mr. Casey. We spent a lot of time trying to develop measures to address the medium or smaller businesses. We just were unsuccessful.

Mr. LaFalce. Most of your recommendations are about a small business that has already been formed—that has potential for expansion—and you are trying to focus in on how you help this kind of business achieve this type of potential that it has. That is a tremendous problem. I think it might be concerned more with high technology types of businesses, too. But I do not think that this addresses the greater problem of the great number of truly small businesses in the country. I do not know whether this report has focused in enough on this problem.

Mr. Casey. We just did not come up with anything. All we could come up with was a loan program. Most of them are going to the banks, but if they are out of that maybe the SBA will help—but that does not finance equity growth.

Mr. Aronson. That was the question I was going to ask you. You said the answer is not for very small businesses. The commercial banks, and indeed the SBA, have programs for the very small to acquire capital.

Mr. Casey. That is not equity capital. They use it for equity. It is not equity but it is used that way.

Mr. LaFalce. They do not even have working capital, and they fold. That is the problem. I hate to be so pessimistic.
Mr. Casey. What we came up with was, let them keep more of their earnings, and let them charge off their capital equipment faster which keeps cash in the business.

Mr. Golden. I have to comment on your suggestion that they fold for that reason alone. They fold because of two things that occur. Maybe they are the same thing.

Mr. Pearsall talked about it, lack of management expertise and counsel, but many times they refuse to accept the counsel that is given to them. They do not take too much loan money. They will overextend themselves because they do not want equity investors. I have seen many cases, where people come in to see us and they will say, I do not care what interest you charge. You cannot have one share of stock.

Mr. Hambrecht. I have just one thing. I think it is important to understand that capital needs are much a function of growth. In other words, if your business profits are low and you are not growing very fast, you really do not need capital from outside. They can do it from your own cash flow. That is why we are confronted with companies with growth promise. They are the companies that have been most successful at job creation, at creating an asset, at creating business.

The smaller businessman who is not really building a business, if he cannot run it on cash flow then he deserves to fold. He is not operating properly.

Mr. Weaver. We have seen small businesses refuse to accept our advice because we are the Government. We are the Feds. For that reason—that is not an exaggeration. For that reason we are hopeful that our SBIC's small business opportunity for colleges and our eight pilot university development centers using the third party approach, the business school, may let small businesses accept their advice a little quicker and more directly.

Mr. LaFalce. I want you to know that not only because of its effect on capital, but because management is a concern of this subcommittee, we do intend in the future to have hearings on the management problem and how the SBA might address it. Particularly, we want to look into the university development centers and possible expansion of that program. I do think that the principal reason most businesses fold is lack of management ability. I am very interested in the VISTA and SCORE programs, but I am doubtful just how effective those volunteer programs can be.

Gentlemen, we can go on endlessly. But, there is a recorded vote right now. I also think there is a recorded vote subsequent to this. So I am going to adjourn this hearing this morning but I want to again express my very very great thanks and again tell you that your work and efforts will not just gather dust and I will see to it that there is considerable attention given to it.

[Whereupon, at 11:25 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]
SMALL BUSINESS ACCESS TO EQUITY AND VENTURE CAPITAL

WEDNESDAY, MAY 18, 1977

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL, INVESTMENT
AND BUSINESS OPPORTUNITIES OF THE
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met at 9:40 a.m., pursuant to notice, in room 2359, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LaFALCE

Mr. LAFALCE. Gentlemen, the subcommittee will come to order.

Today, our subcommittee begins its second day of hearings on the subject of the small businessman's access to venture and equity capital.

In our first hearing, we were fortunate to have the views of a number of individuals who participated on the SBA task force on this subject as well as the new Administrator of the SBA.

A good many of you were present as observers. We certainly received some informed views last week, and this morning we have, of course, a number of equally qualified witnesses. We have a number of witnesses, and I hope there will be lively discussion after the testimony is heard.

I would like to call up all of the individuals who will be testifying this morning and have each of you in order give your testimony or a summation of it. Then we will have questions from the congressional panel, and then a discussion among the panelists. We have with us Mr. Lamar E. Ozley, Jr., Mr. James F. Hansley, Prof. Patrick R. Liles, Mr. M. William Benedetto, Mr. Russell L. Carson, and Mr. Walter B. Stults.

Mr. Ozley, president-elect of the National Association of Small Business Investment Companies, would you please begin?

TESTIMONY OF LAMAR E. OZLEY, JR., PRESIDENT-ELECT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, DALLAS, TEX.; ACCOMPANIED BY WALTER B. STULTS, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, WASHINGTON, D.C.

Mr. Ozley. Thank you, Mr. Chairman.

I might note for the record that the schedule of witnesses reflects that I am from New York. You have probably suspected by now that that is in error.
I am Lamar Ozley, chairman, Interstate Venture Capital Corp., a privately owned SBIC with its office in Dallas. In addition, I serve this year as president-elect of the National Association of Small Business Investment Companies, the trade organization which represents over two-thirds of all licensed SBIC's and MESBIC's.

Our members account for about 90 percent of the billion dollars of assets in the SBIC industry today. Accompanying me today is Walter B. Stults, executive vice president of NASBIC.

On behalf of the industry, I wish to thank you for initiating this series of hearings on the important subject of the ability of small business to raise equity and venture capital.

I believe this area is one of the two or three most crucial problems in our national economic life. Fortunately, the SBIC experience over the past 18 years has given us some insights into methods for increasing the flow of equity dollars to new and growing businesses, so your hearings and recommendations have the potential for pointing out solutions to the present problem.

COMMENTS ON THE REPORT OF SBA's TASK FORCE

Mr. Chairman, let me say at the outset that we applaud the very fine work of the SBA Task Force on Venture and Equity Capital, headed by William Casey.

NASBIC supports all 19 of the task force recommendations, many of which are also part of our own redesign package. We shall add certain proposals of our own, but the task force furnishes a firm base for these other recommendations.

We believe it is most significant that this group of eminent and highly qualified individuals—all but three of them from outside the SBIC industry—came to the same fundamental conclusions as NASBIC did.

The Casey task force concluded that "venture capital for new and growing small businesses has become almost invisible in America today." NASBIC agrees with that finding and will expand slightly upon it in the next section of this testimony.

At this point, I also call the subcommittee's attention to the report submitted last December to the Secretary of the Treasury by the Treasury Small Business Advisory Committee on Economic Policy. Most of its recommendations closely parallel those in this NASBIC testimony and it specifically stated that: "We strongly urge the Treasury Department to give its full support to the Casey task force's proposals."

I ask unanimous consent that the Treasury Department Advisory Committee Report be included in the hearing record as a part of my remarks.

Mr. LAFALCE. Without objection, it will be included.

[The report referred to follows:]

Table of Contents—Recommendations:
A. General
B. Tax policy
C. Equity capital
D. Long-term credit
E. Government paperwork and regulation

During a meeting of the Advisory Committee on December 7, 1976, the Treasury Small Business Advisory Committee on Economic Policy adopted and presented to the Secretary of the Treasury the following set of recommendations. The Committee requested that the Secretary of the Treasury present the recommendations to the new Administration and new Secretary of the Treasury; and the Committee voted that the following report be attached to the transition briefing material presented to the new Secretary of the Treasury.

A. GENERAL

1. We recommend and think it is essential that this Advisory Committee spend a great deal of its available time creating an awareness and understanding of small business concerns within Treasury, the IRS and other regulatory agencies. We further believe that this effort should take place at both the Presidential appointment level and Civil Service level and that it should focus on the problems, the nature, and the needs of small business. Therefore, we propose that the Secretary of the Treasury communicate on behalf of this Committee to the representatives of the new Administration our hope that President-elect and his tax advisers will consider:
   (a) The relative needs of large and small businesses for tax reduction as a stimulus to growth, and
   (b) The relative share of large and small companies in the benefits of any tax reductions.

2. We recommend the continuation of the Small Business Advisory Committee to the Treasury Department.

3. We recommend the appointment of an Assistant Secretary or a Special Assistant to the Secretary for Small Business—a person who reports directly to the Secretary.

B. TAX POLICY

Recognizing that Federal taxation has the greatest adverse impact on capital formation for the bulk of all small independent business, the Committee ranked tax policy as its highest priority. In principal we support H.R. 13687, the COSIBA small business tax bill, but we have focused on several items which we recommend for adoption or study. The first three items constitute the principal recommendations of the Small Business Administration Venture and Equity Capital Task Force chaired by William Casey.

1. Adjustment of depreciation schedules
   A taxpayer would be permitted to write off any amount up to and including 100% of an asset value in year of acquisition.
   Limitation: $200,000 per year, in the case of eligible property and $200,000 per year, in the case of real estate.

2. Adjustment of corporate rates
   Revise the existing corporate tax rate structure to reflect the following changes:
   
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<th>Taxable income</th>
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3. Transfers of stock in qualified small business corporations
   If an investment is made in a qualified small business concern (per established SBA guidelines) subsequent to January 1, 1977 and is ultimately disposed of after...
a two-year holding period at a gain, taxation of the gain will be deferred if the proceeds are reinvested in a qualified small business concern (per established SBA guidelines).

Gain would be recognized on a current basis to the extent that proceeds from the sale exceed the amount reinvested.

4. Increased surtax exemption

As an emergency, temporary action pending adoption of all of these tax recommendations, we strongly support the increase of the corporate surtax exemption to $100,000.

5. Income averaging

We recommend that corporations be able to "income average" by permitting them to carry-over unused surtax exemptions. We suggest a 3-year carry back or a 5-year carry forward or 8-year carry forward similar to the net operating law provisions in the 1976 Tax Reform Act.

6. Partial deduction for the cost of equity

We feel that proposals for tax integration through a credit given on the payment of dividends by corporate taxpayers is seriously deficient and would have an adverse affect on small business. We believe that the proposal outlined by Professor Anthony in the November 29 issue of the Wall Street Journal of further investigation and evaluation. We, therefore, recommend that Treasury consider and analyze Professor Anthony's proposal.

7. Accumulated earnings

We recommend that accumulated earnings of corporations be allowed to rise to $500,000 instead of the current accumulation ceiling of $150,000 and that regulations be written to state clearly what will be considered to be an unreasonable accumulation.

8. Tax payment limitation

We recommend that the total Federal tax payments during any year (the current year's estimated tax payments, plus the amount due on the previous year's tax liability) shall not exceed 125 percent of the prior year's tax liability. This provision would affect only a small number of firms growing at a rapid rate. Any amounts carried on to the following year shall bear interest at the current rate required for late payment.

9. Working capital investment credit

The present tax investment credit is biased in favor of those firms which utilize capital equipment. We recommend studying a proposal that would allow a 10 percent tax credit on the first $250,000 earnings for all businesses, whether or not they could use the investment credit provisions of the present code.

10. Tax credit for those who make SBA-guaranteed loans

A credit of 20 percent of the gross interest income would be an easy recommendation to administer and would give a great incentive for banks to generate SBA-guaranteed loans and for institutional investments to purchase the guaranteed portion of such loans. The Treasury Department has recommended this action in 1970 and 1971, and we support it fully.

11. We specifically request that the Secretary call to the attention of the economic advisors to the President-elect a study prepared for the use of the Subcommittee on Economic Growth of the Joint Economic Committee: "Employment Tax Credit as a Fiscal Policy Tool."

12. We recommend that the new Administration give the most serious consideration to an employment tax credit which will in some measure put a premium on employment in the independent small business sector of the economy as against either government or large corporation.

13. We request that the Treasury staff comment specifically on the methodology and conclusions contained in the econometric study conducted by Messrs. Fethke and Williamson and to reconsider and review estimates they have furnished to us of the net cost of the job creation tax credit.
C. EQUITY CAPITAL

The government estimates that small business faces an annual shortfall of equity capital for the next ten years of some $7 or $8 billion. This is a tremendous sum for the sector of our economy which has practically no access to the public securities markets or to institutional sources of funds. We make specific recommendations in three areas:

1. **ERISA**

   Either by statutory amendment or by Executive Branch cooperation among the Treasury and Labor Departments and the Small Business Administration, the fiduciaries responsible for investing the $210 billion of pension funds should be told that small business investments are as permissible and acceptable as any others within the “prudent man rule” of the statute. We find the inability of Treasury to clarify the meaning of the “prudent man rule” because it falls under the Department of Labor’s jurisdiction—and Labor’s apparent unwillingness to do so—most harmful to the interests of a free enterprise-economy.

2. **Securities laws and regulations**

   a. By legislation or regulation, there must be an increase in the present limitaton on Regulation A offerings up to at least $2 million.
   b. Rule 144 should be amended to allow those who invest in new and small businesses to recycle their funds more promptly; thus allowing them to invest in more new and small firms.
   c. The private offering exemption under Rule 146 should be studied carefully to see if that exemption cannot be made more useful to small businesses.

3. **Venture capital companies and SBIC’s**

   The SBA Task Force under the leadership of William Casey is presently considering a number of recommendations for increasing the effectiveness and augmenting the resources of this most important segment of the financial community. We shall not duplicate that group’s work, but we strongly urge the Treasury Department to give its full support to the Casey Task Force’s proposals.

D. LONG-TERM CREDIT

   Academicians might consider that credit is an appropriate topic for a group studying “capital formation.” Real life proves, however, that a five-year loan is as close as many small businesses get to outside capital. Certainly, we believe that no one would doubt that it is preferable for smaller firms to have the bulk of their liabilities in the form of term loans, rather than 90-day lines of credit or commercial finance funds on an equally short basis. For that reason, we recommend two proposals as a spur to the availability of small businesses to obtain long-term credit. The first proposal—a tax credit for those who make SBA-guaranteed loans—is listed as item 10 under the tax policy section above. The second proposal is SBA Support for Restructuring Short-Term Debt.

   SBA guidelines discourage banks from restructuring a small firm’s loans even though it might be in the best interests of the small business. We would recommend that SBA regulations permit banks to roll over their lines of credit or shorter loans into a term loan, up to seven years. SBA might wish to make its guarantee for less than 90 percent, but we do not feel that the fear of sharp dealings by a few should automatically rule out actions which would be most helpful to small business.

E. GOVERNMENT PAPERWORK AND REGULATIONS

1. We recommend that the next IRS Commissioner, Secretary of the Treasury and the Director of OMB all participate actively and directly in the Commission on Paperwork and Regulatory Reform. We also recommend that the Treasury and IRS work more closely on paperwork reduction.

2. With the advent of the computer along with our present ability and high technology, we recommend that all government agencies work toward achieving the goal of two reports per year, one for tax data and one for non-tax data. This would force better control and justification of public reporting requirements and regulations. We recommend that Treasury take the lead in this endeavor.
Most observers agree that measures to stimulate the formation of capital are urgently needed. Without such measures, some estimates are that there will be a "capital shortage" of billions in the next decade.

Most observers also agree that the capital shortage is caused in part by the fact that the Internal Revenue Code discriminates against equity capital, as compared with debt capital. The interest on debt capital is a tax deductible expense, so the real cost of debt capital to a company is only half its pretax cost. There is no corresponding tax deduction for the cost of equity capital, so its real cost is equal to its pretax cost. Thus, the effective cost to the company of funds obtained from a 9% bond issue is 4.5%, while the effective cost of funds obtained by the sale of common stock at a price that investors expect to return them 12% is the full 12%.

This difference between the effective cost of debt capital and of equity capital is so great that companies are strongly motivated to use debt capital as a source of funds to the point where debt/equity ratios are dangerously high. The disastrous experience of real estate investment trusts is in part traceable to the thinness of the equity portion of this method of real estate financing. The economy cannot expand at an acceptable rate and with a sound capital structure unless the flow of equity capital is large enough to provide a proper balance with debt capital.

Most tax reform proposals designed to redress the balance between debt capital and equity capital involve giving special tax treatment to distributed profits, that is, to dividends. Dividends are the only corporate distributions that are taxed twice, once at the corporate level and a second time as income to the recipients. Wages, salaries, debt interest, and rent are taxed only once, as income to the recipients. Income of unincorporated businesses is also only taxed once, to the recipients. Relief from this double taxation of dividends would appear to correct this imbalance, thus making equity capital relatively more attractive and creating the necessary impetus for equity capital formation.

TWO APPROACHES

Two general approaches are proposed. One is to make dividends, or some fraction of dividends, a tax deductible expense at the corporate level. The other is to exclude dividends, or some portion of dividends, from taxable income of the recipients. Unfortunately, there are serious defects in each of these proposals. If dividends were made tax deductible at the corporate level, the result obviously would be that the effective cost of new equity capital would be reduced, and this would make obtaining new equity capital more attractive to the corporation. This is good. But the result also would be that corporate boards of directors would be under pressure to pay out a large fraction of earnings as dividends, because the larger the dividends the lower the corporate income tax. Since total corporate earnings are either distributed or retained, the larger the fraction that is distributed, the smaller is the amount retained. Currently, retained earnings are about six times as large as the amount of equity capital raised from new stock issues. The corporate income tax would become, in effect, a tax on undistributed profits, and thus discourage the retention of earnings.

In 1958, West Germany instituted a dividend deduction at the corporate level for the express purpose of encouraging the flow of corporate earnings into German financial markets, thereby rebuilding those markets. The New York Stock Exchange favors such an approach. Although the stock exchange uses the stimulation of equity capital formation as its basic argument, it is possible that the additional brokerage fees that would presumably be generated as increased dividends are reinvested is relevant in its thinking.

But the distribution of income as dividends and its reinvestment by the recipients either in the same company or in other companies does not create additional capital. It merely shifts the source of capital from retained earnings to new equity financing. Indeed, unless recipients reinvested all the additional dividends, which is unlikely, the effect could be a net reduction in total capital formation.
The alternative approach, in which dividends are made wholly or partially tax-exempt to the recipients, has two flaws.

First, the tax relief relates only to that part of the cost of equity capital which is paid out in dividends. Total equity costs are almost always higher than dividends, and since the fraction of the total cost that is represented by dividends varies from company to company, the impact would be uneven. In particular, investors in rapidly growing companies would be penalized; these companies cannot pay high dividends because they need to retain earnings for growth.

The other problem with this approach is that the American public is likely to regard even a partial dividend exemption as unpalatable. Dividends are thought of as something rich people get, and dividend income as being unearned income. Moreover, it would be difficult to explain why the person who receives interest is treated differently from the person who receives dividends, since both are payments for the use of capital. Interest would be a deduction at the corporate level and income to the recipient, but dividends would not be a deduction at the corporate level and would not be income to the recipient.

The basic trouble with any dividend approach is that it assumes implicitly that dividends are the cost of equity capital in approximately the same sense that interest is the cost of debt capital. This is not the case. Interest is the cost of debt capital. For equity capital, however, dividends are only a fraction of the true cost. The dividend yield on listed common stocks averages roughly 3% of market value which obviously is far less than the real cost of equity capital.

What is needed is a method of removing the tax discrimination against equity capital that is not geared to dividends. There is a simple, practically loophole-proof way of doing this: Allow corporations to take a tax deduction that is related directly to the amount of their equity capital. That is, allow a certain percentage of shareholders' equity as a deductible expense on the corporate income tax.

Such proposals to record the cost of equity capital have been made in other contexts, but they have been largely ignored by practical people. Practical people know that there is no objective way of calculating a company's true cost of equity capital, and they therefore have assumed that there was no practical way of implementing such a proposal.

A PRACTICAL WAY

There is in fact a practical way. It is simply for the Congress to establish a percentage which would be applied uniformly to the shareholders' equity of all corporations somewhat below the average company's cost of capital. It might be thought of as a "prime equity rate," analogous to the prime rate on medium term debt. In order to phase it in gradually, the tax deduction could be, say, 2% of shareholders' equity in the first year, gradually increasing to a top in the neighborhood of 7%. (Many companies apply a rate of 5%, 6%, or 7% to shareholders' equity to arrive at a deduction from income which is used in calculating the size of the bonus pool for executive compensation.)

The great advantage of this proposal is that it is completely unrelated to dividends. Consequently, directors can select the balance between dividends and retained earnings that best fits the company's needs without the pressure that special tax treatment of dividends would cause.

A tax deduction for only a portion of the cost of equity capital would not eliminate entirely the disparity between equity capital and debt capital, but neither would favorably tax treatment for dividends, unless the law motivated companies to pay out all earnings as dividends, which would be disastrous. It would lessen the disparity, and this is all that reasonably can be hoped for in any proposal.

The method would be easy to apply. It requires only that the book amount of shareholders' equity, as shown in the company's accounts, be adjusted for the differences between taxable income and income as reported in the financial statements. The differences already appears in the company's accounts, although ordinarily not in the shareholders' equity section. The tax deductible amount would be found simply by applying the prescribed rate to the shareholders' equity. The corporation would continue to pay an income tax on the net after this deduction.

What effect would this proposal have on tax revenues? Taken by itself, a deduction for equity interest would of course reduce total revenue from income
taxes. This is the case with all the proposals to alleviate the double taxation problem, and responsible advocates of any proposal recognize the necessity of an offsetting change so that the total tax take would not be reduced. The various offsets that have been proposed can be applied with the proposal made here.

Mr. Ozley. In his recently published study of venture capital, Prof. Patrick Liles of the Harvard Business School pointed out that "various schemes to provide sources of financing for small and new businesses have been part of a recurring economic and political debate since the early 1930's."

Professor Liles summarized the different proposals put forth between 1932 and 1958 when the Small Business Investment Act was passed by Congress and signed by President Eisenhower. Throughout that quarter century, almost every serious commentator agreed that an equity gap existed for new and small businesses, but found more difficulty in assigning dollar figures to the extent of the shortage.

While this act has at least recognized the problem and taken a step toward curing it, we feel the equity gap still exists and from personal experiences, I can assure you there is a dire need for capital on the part of almost all small businesses in this country as well as new and emerging businesses.

Even today, it is possible to argue that there is no equity gap. I suppose the true disciple of Adam Smith would say that the free market would take care of the truly good investment opportunity—and that any business unable to find capital is not a qualified applicant.

I am afraid I must dispute the wisdom of Adam Smith in this regard. I know from experience that this unique government-private enterprise undertaking we call the SBIC industry has provided financing for tens of thousands of worthy entrepreneurs who had no other source of dollars.

My own SBIC has stepped up and disbursed venture capital to a small businessman after all the traditional suppliers were tried unsuccessfully. Many of these SBIC financings have turned out well, too—belying the conclusion that good applicants can always find the money they need without help from a Government-sponsored program.

NASBIC has tried to put some sort of numbers on the size of the equity gap, but we have not been successful. We can point to the $1.5 billion raised through public stock offerings in 1969 by 548 small businesses going public for the first time and contrast it to the $16 million raised by the four small firms which went public in 1975 and conclude that the intrinsic need could not have dropped so sharply in that 6-year period.

We all know that it costs more today to start a business and that it requires more to turn it into a profitable operation. We know that retained earnings remain the chief source of capital for small businesses—and that present tax laws take away more of the earnings of businesses than was the case before World War II.

Finally, we know that the Federal tax laws give little or no incentive for individuals to invest in small businesses—and other Federal laws all but prohibit institutional investment in smaller firms. For all these reasons, we can safely infer that the equity gap remains.

In addition, we have strong empirical evidence that thousands of new businesses would be formed and that thousands of other present concerns would grow significantly if they had access to equity capital.
We point to those areas of the United States where there is a concentration of equity capital and find a record of birth and growth of businesses which is far above the national norm.

I don't think we should conclude that all the brains and all of the entrepreneurial drive just happen to reside around route 128 outside Boston or in Santa Clara County in California or several other similar communities.

No, I am certain that businesses are born and grow in those places, because equity capital sources are available there.

To conclude this brief discussion of the existence of an equity gap, I would like to quote from an address presented to the NASBIC annual meeting in November 1976. Mitchell Kobelinski, then Administrator of SBA and a member of President Ford's Economic Policy Board, told us that his agency had worked with data supplied by all parts of the Government and said: "We estimate that small business faces a shortfall in venture and working capital that will average from $7 billion to $8 billion a year over the next decade."

Are SBIC resources sufficient to fill the equity gap?

Our answer to that question is certainly negative. We know that SBIC's have been disbursing equity and loan funds over the past 5 or 6 years at an annual rate of between $125 million and $200 million.

The SBA statistics indicate that equity investments constitute between 50 percent and 60 percent of the annual total, with the rest in the form of straight loans.

Based on Mr. Kobelinski's estimate, it is apparent that the unfilled demand is sufficient to require a major growth in the size of present SBIC's and the addition of many large SBIC's to the program. As you know, there are now about 275 active SBIC's with private capital approaching $450 million and total assets standing at about the $1 billion level.

Although the statistics on activities of non-SBIC venture capitalists are not available, we estimate that they disburse less annually than do the SBIC's. Thus, both segments of the venture capital industry fall far short of meeting the demands posed by the equity gap.

Why hasn't the SBIC industry grown more rapidly?

If we conclude that the equity gap remains with significant numbers of qualified applicants for SBIC-type financing—and that the SBIC industry is not large enough now to meet those demands, then we must ask why our industry has not grown to fill the gap.

The answer is simple: The SBIC industry just has not been profitable enough to attract more private dollars.

SBA requires financial reports from all SBIC's each year, compiles those numbers, and makes them public. By and large, the consolidated financial reports for SBIC's make sad reading. The annual rates of return on investment have never been very high, and, worse, in many years, the industry has shown a negative return on its private capital.

Naturally, within those overall figures, much is hidden. Some SBIC's have been able to compile outstanding performance records with high realized earnings or annual gains in net asset values.

In total, though, the profit rates, even over a long period, have been too low to encourage additional investors to join our important undertaking.
What is to be done? NASBIC's leadership has devoted almost all its time and resources for the past 6 months to come up with answers to that question. In April, the Association's Board of Governors gave its approval to a 20-point legislative and regulatory program to revitalize not only the SBIC program, but the entire small business community as well.

With your permission, Mr. Chairman, I would like to insert our position paper in your hearing record at this point.

Mr. LaFalce. Without objection, it will be included.

[The document referred to follows:]
Irving Kristol spoke to the hearts of 10-million American entrepreneurs last Fall when he wrote in the Wall Street Journal that "a whole new class of forgotten men has emerged -- the small businessmen". Professor Kristel granted that "small business is of lesser economic significance than it used to be, but its economic role is still terribly important" and "small business preeminently is the private sector." He concluded that the survival of small business in the United States, despite its crucial role in innovation and job creation, is much in doubt today "and much that is precious to the American way of life will perish" if the independent sector dies.

Viewed solely as a series of statistics, small business remains a major factor in our economy. There are almost 10-million of us who generate about 43% of the total Gross National Product and employ 55% of the business work force. On the other hand, the predominance of major corporations has increased tremendously over the past four or five decades. The Fortune 500 are the firms which hold the bulk of all manufacturing assets and which almost exclusively can tap the public securities markets and the growing resources of institutional lenders and investors. With heavy tax burdens and an inability to raise external funds, small and medium size businesses find it almost impossible to grow. Furthermore, they cannot innovate with those new products and services which would keep our economy truly competitive.

Almost nineteen years ago, Congress passed the Small Business Investment Act which contained this statement: "It is declared to be the policy of the Congress and the purpose of this Act 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 funds which small business concerns need for the sound financing of their business operations and for their growth, expansion and modernization...".

The first SBICs were licensed by the Small Business Administration in March 1959. Currently, 275 SBICs are in operation with private capital of almost $425-million and assets approximating $1-billion. During the past 18 years, SBICs have disbursed almost $3-billion to some 50,000 new and growing small businesses.

Taken alone, those numbers are rather impressive for such a pioneering industry, but they must be viewed in a broader perspective. Let's contrast those figures with the dollars raised by small business which went public for the first time in 1969. In that year alone, some 700 businesses with net worth under $5-million sold public offerings of stock for the first time and raised $1.4-billion -- that's almost half as much as SBICs have disbursed throughout the
history of the program. Of course, the "hot new issues" market folded in the mid-1970's and in 1975, only 4 small businesses were able to go public and they raised a total of $16-million. With an annual disbursement rate of under $200-million, SBICs were not able to pick up the slack caused by the end of the public issues market -- let alone fill the other categories of the "equity gap".

NASBIC is convinced that this is the year for a thorough analysis of the current health of the independent sector of the American free enterprise system -- and that the vigor of the venture capital and SBIC industries is completely intertwined with the vital signs of the small business community.

During the past year, several significant studies bearing upon the vitality of small business were completed. The Council of Small and Independent Business Associations (COSIBA) designed and drafted a comprehensive Federal tax bill which would dramatically bolster the survival and growth potential of independent business. At the same time, a Task Force on Equity and Venture Capital appointed by the Administrator of SBA issued a dramatic report containing recommendations in that area. Also during 1976, the Secretary of the Treasury appointed an Advisory Committee on Small Business Economic Policy which agreed on a wide-ranging series of proposals to strengthen smaller firms. Finally, the National Venture Capital Association issued a White Paper entitled "Emerging Innovative Companies -- an Endangered Species." These are several of the blocks upon which this study is built.

Herbert Krasnow was elected NASBIC President on November 3, 1976; he immediately called upon the Association's Board of Governors to suggest changes in the design and operations of the SBIC program which would make it more effective in channeling additional billions of dollars to hundreds of thousands of new and growing businesses.

The NASBIC Board of Governors and its Executive Committee have now concluded the first phase of their survey and, in this paper, introduce their proposals for strengthening the SBIC industry.

ASSUMPTIONS

We start with two basic assumptions, but the two are inter-related. First of all, we are convinced that American business in 1977 confronts an "equity gap". Smaller firms this year, as always, are last in line when scarce equity capital is doled out, so any general shortage impacts most heavily on the new and the small. We know that present SBICs cannot meet all the requirements for venture capital and long-term loans. Furthermore, we are certain that no adequate non-SBIC sources of such dollars exist to augment SBIC funding. The public securities markets are all but closed to small issues; insurance companies and other institutional sources of capital
and credit can seldom be tapped by the owner-managers of independent businesses. The SBA bank guaranteed program is an important asset for small business, but it does not attack the equity capital short-age.

For all these reasons, and others, we must conclude that SBIC resources are insufficient to meet the demand posed by qualified companies. If that is the case, why has supply not increased enough to meet the demand? This brings us to NASBIC's second assumption: present SBICs have not been profitable enough to attract the capital and the loans they need to grow -- nor has the record of profitability been sufficient to bring enough new SBICs into the program.

These then, are the basic assumptions upon which our proposals are based: (1) the equity gap remains, so the SBIC program must be larger, but (2) it has not demonstrated rates of profit which would bring more private dollars and more companies into the industry.

I. INCREASING SBIC PROFITABILITY

During the history of the program, some SBICs have been able to compile outstanding performance records with superlative realized earnings or annual gains in net asset values. On the other hand, the overall industry record has been far less satisfactory. SBA issues an annual compilation of SBIC financial statements and the red-ink years have outnumbered those where profitability was the norm. Furthermore, in today's world, quick capital gains appear to be only a fond memory. Few small or medium sized firms are able to go public -- and even when they do, the venture capitalists which backed them can seldom sell their shares. In addition, the merger fever has abated, so the fast-growing innovative firm no longer can sell out at 100 times earnings to the hot conglomerate.

So -- it's back to fundamentals for SBIC managers; they, too, must try to cover their expenses and make their earnings on the spread between their cost of money and the price they charge for it.

It should be noted at this point that SBIC activities have resulted in a significant profit for the Federal Government. Uncle Sam's return on its investments in the SBIC program has been far better than have been the profits garnered by SBIC shareholders themselves.

During the past 10 years, SBICs have been paying between 7% and 9% for the leverage they obtain from the Small Business Administration. With that basic cost added to the licensee's expenses and reserves, it's apparent there is little room for profit. With full recognition of that fundamental fact, NASBIC makes this first, and most important recommendation:
A. The Federal Government should partially offset the cost of leverage, so SBICs will not have to pay more than 3% annual interest for new leverage.

For every leveraged SBIC, the cost it must pay for its borrowings is the highest expense item on its P&L. If these borrowed funds were less costly, the SBIC will surely be able to show a better profit picture. Moreover, it would be able to make many loans and investments which are not feasible today with the significantly higher cost of money.

If the Small Business Investment Act is amended to permit this subsidized leverage for regular SBICs, the Federal Government will bear a cost which is not directly offset by SBICs. On the other hand, that expense will be more than repaid by the additional taxes paid by the small businesses which receive the SBIC loans and investments and by the thousands of new employees added by SBIC portfolio companies. Official SBA surveys have proven that the Federal Government obtains tremendous dividends from the current operations of the SBIC program; even with the initial cost of subsidized leverage, the Government will receive millions of added dollars in taxes from the accelerated and expanded pace of SBIC activity under the new plan.

We believe the program for subsidized leverage should be in addition to the current SBA-Federal Financing Bank funding plan, rather than a substitute for it. The SBIC industry remembers all too well the chaos created by the unavailability of leverage during the first 12 years of the program when SBA and SBICs depended upon directly appropriated funding.

B. Defer capital gains taxes when proceeds of the sale of stock issued by a small business are reinvested in an eligible small business concern.

The greatest moment in the life of a venture capitalist comes when he is able to generate hard dollars through the sale of his long-held stock (usually about 10 years) of a successful portfolio company. That's the culmination of rigorous analysis of a promising investment opportunity, proper structuring and pricing, continuous counseling, and an imaginative exit technique on the part of the SBIC manager or other investor. Less exciting, though, is the heavy burden of Federal and State taxation which will take away about 50% of the capital gain so generated. There's a contradiction in this situation: the Federal Government has established and encouraged the SBIC program as a matter of public policy to provide capital to small business, but the same Government decimates the flow of such funds through the imposition of onerous taxation.

Undoubtedly, one of the worst threats to the continuation of the free enterprise system is contained in the Internal Revenue Code.
Our tax law permits tax-free reorganizations which provide an irresistible incentive for the owners of a successful small business concern to sell out to a major corporation, since there is no immediate tax consequence of such a merger, so long as they take the stock of the big business in return. This provision of the Code lessens competition and compromises the free market system.

To offset this serious danger, NASBIC strongly urges that the tax law be made at least neutral. We propose an amendment to the Code which would encourage further investment in other small businesses. Taxation of capital gains arising from the sale of stock in a business firm which was small when the security was acquired, would be deferred when the proceeds of that sale were reinvested in a small business concern within a two-year period. There is a clear precedent for this amendment, both in the current corporate reorganization section and in the deferral of taxes on the sale of a residence.

C. Allow all SBICs to pass through their earnings to their shareholders without the imposition of a corporate tax.

It is our goal to attract different types of investors to the SBIC program. To those who are particularly interested in capital appreciation through the growth of the SBIC, the capital gains provision outlined above is especially attractive. Other investors, though, have the need or desire for current income, so they would be more likely to invest in SBICs which pay regular dividends. At the present time, publicly-owned SBICs which are registered under the Investment Company Act of 1940 may avoid corporate taxes on their earnings so long as they pass through at least 90% of their profits to their shareholders. This authority has proven to be most valuable to several of the public SBICs which have increased their private capitalizations regularly over the life of the program.

We believe that all SBICs should be given this authority whether or not they are publicly-owned. Although this position may appear at first blush to contradict our goal of bringing more capital to the program (since earnings will be distributed, not retained), we are certain that the payment of regular dividends will indeed attract many millions of dollars of new capital to those SBICs which are primarily income-oriented and, thus, able to pay such dividends to their shareholders. Present SBICs will get the new capital they need to grow and new SBICs will be formed, we are sure, if the pass-through provision is approved.

D. Provide a statutory loss reserve of 10% for SBICs based upon equities, as well as debt securities.

No matter how we redesign the SBIC program, one constant will remain: the high level of risk involved in providing financial
assistance to new and small businesses. Over the past 18 years, SBICs have grown more skillful in screening out the doomed investments and in protecting themselves against losses, but every SBIC will inevitably have to swallow its share of complete or partial losses. At present, the Internal Revenue Code permits an SBIC to set up a reserve for bad debts based upon its experience, but this authorization is seriously deficient in two respects: first, for an SBIC, the past is no certain guide to the future. An SBIC may be fortunate enough to have minimal losses for 10 or 12 years and then it may have two or three deals go sour in a very short period. We believe it would make good business sense for the SBIC to set aside a reserve to take care of such unexpected losses. The second problem with the current law is that it allows for losses only on loans and not on investments, even though the latter are ordinarily far more risky. The NASBIC proposal then, would have the law permit any SBIC to establish a reserve against losses in an amount up to 10% of its total portfolio, both loans and investments. Here again, the change would encourage further equity investments.

These four specific recommendations would make a significant contribution to the profitability of SBICs and we are certain they would encourage hundreds of millions of additional dollars to come into the SBIC program, both into existing licensees and into new ones. The major beneficiaries of these changes, however, would be: (1) new and growing small businesses; (2) the Federal Government which would reap greatly expanded taxes from the small businesses assisted by SBICs and from the new workers employed by those growing firms; and, (3) the economy which would receive new products and services at lower prices through increased competition.

II. PROVIDING START-UP CAPITAL FOR NEW BUSINESSES

If venture capital is in short supply for growing businesses, it is all but non-existent for new concerns. Of course, the savings of the would-be entrepreneur and his family can be invested today, as always, but in almost every field of endeavor, the ante for getting into operation is far higher than it used to be. Henry Ford may have started an automobile company in his garage, but today's innovator can seldom take the boot-strap route.

More typical in 1977 is the record of such firms as Cray Research, Amdahl Computer, or Federal Express. For these businesses to proceed from concept to market required tens of millions of dollars provided by many institutional venture capitalists. We are aware of these three companies, because they are the striking examples of high stakes start-ups which were funded and are now in business. On the other hand, no one knows the names of the thousands of equally innovative entrepreneurs who possessed similar expertise, but whose dreams never proceeded beyond the drawing boards.
The still-birth of these companies is a vital factor in our national economy. They could have brought new products or new services to the United States. They would have produced greater competition and lower prices; and they would certainly have generated meaningful jobs for thousands of our citizens who are now unemployed or under-employed at the present time. A study undertaken for the Department of Commerce by the M.I.T. Development Fund gives dramatic proof of the benefits generated by new, high-technology firms. The M.I.T. survey focused on six mature companies; five innovative companies; and five young, high-technology firms. Here is the average annual record of each group for the five years between 1969 and 1974: (1) the mature companies showed an annual sales growth of 11.4%, but those sales increases were accomplished with an average growth in employment of only 0.6%; (2) the successful, innovative firms grew slightly faster, or 13.2% a year during the period; (3) BUT, for the new high technology firms, the average annual sales growth was 42.5% and the increase in employment averaged 40.7% each year. Quite obviously, the United States has a major stake in the formation of such firms.

Although SBICs have financed a number of start-ups each year, they are finding it increasingly difficult to justify the higher risk, the greater costs, and the lengthy locked-in period which inevitably accompany investments in new businesses. For all those reasons, NASBIC makes the following recommendation:

The Federal Government should share in the higher risks associated with start-up investments. In such situations, the Government should guarantee 75% of the losses incurred by SBICs on start-up situations.

We are certain that this risk-sharing will encourage SBICs to devote a higher percentage of their assets to the formation of new business. At the present time, the risk-reward ratio is so unfavorable that SBIC management can justify only a very few start-up investments. The proposed 75% guarantee will alter the risk-reward ratio sufficiently to convince SBICs to disburse a larger percentage of their dollars in the form of true equity for start-up. On the other hand, enough of the SBIC's investment will remain at risk to ensure that it will bend every effort to keep the new business solvent. Incidentally, it should be noted that the guarantee will not reimburse SBICs for the added costs associated with start-up investments.

It would not be difficult to define a "start-up" business for purposes of this proposal. NASBIC makes these suggested criteria: (1) any firm (or related enterprise performing similar activity) which has not been in existence for more than one year; OR (2) any firm which has been in existence for less than five years and meets these two criteria: (a) never had annual revenues in excess of $250,000 and (b) never has had a profit; OR (3) any firm which is determined as a "start-up" by the Small Business Administration.
We believe that this rather dramatic change in the SBIC format is fully justified by the significant role that new businesses have played in the American economy -- and can play in the future. This sharing of risks will bring new products, new services, new employment, and new processes to the Nation; it will increase competition and lower prices. It represents a high-priority investment in the future of our free enterprise system.

III. FLEXIBILITY FOR SBICS

In its review of the present design of the SBIC program, the Association identified nine specific statutory and regulatory changes which would significantly assist licensees in providing more financial assistance to more small business concerns. None of these proposed amendments to laws or regulations are new (we have pressed for all of them for a number of years) and none would require any expenditures or increased obligations by the Federal Government. None alone would dramatically augment the size or activity of the SBIC industry, but together they would result in the channeling of additional millions of dollars annually to thousands of new and growing independent businesses.

The first five proposals are directed at the Small Business Administration and we believe none of the changes should present any great difficulty for the policy makers at that Agency.

A. SBA should promulgate liberalized size standards for firms to become eligible for SBIC assistance.

Despite all the changes in the real world, SBA size standards are little changed from the formulas set 18 years ago. In the early 1960's, thousands of new and small businesses were able to go to Wall Street for additional capital; today, that path is closed for all but the largest and most profitable companies. Nonetheless, the SBA size standards would lead one to believe that nothing has changed. Eighteen years ago, the costs for getting into business -- or the expenditures required for a firm to expand from a local to a national market -- were far lower than they are today. Throughout this period, the American economy has proceeded much farther down the road toward concentration of sales, assets, and economic power. In 1977, there is a well-defined and broad "no-man's-land" where businesses are too big to receive SBIC help, but still much too small to obtain capital from the public or from other institutional sources.

For all of these reasons, NASBIC proposes the following changes in the SBA size standards for SBIC financing purposes:

1. The financial size standards should be raised to $15-million in assets, $7.5-million of net worth, and an average annual pretax profit for the past two years of $2-million.
2. The employment criteria should be doubled.

3. The gross revenues tests for specific industries should be reexamined and revised upward to a level appropriate to today's economic conditions.

4. SBA should create a mechanism for regularly reviewing the SBIC size standards to compensate for inflationary and economic changes.

5. SBA should establish size criteria for new industries on a timely basis.

B. SBA should recognize non-cash gains as earnings of SBICs.

In the days of a hot over-the-counter stock market, SBICs were usually able to sell off the stock they held in successful portfolio companies. That is seldom possible today, and the SBIC often sells that appreciated stock to the business itself or some other purchaser who will give a note for a part of the purchase price. Tax law recognizes such a sale as a taxable event; CPAs recognize that sale as giving rise to a gain by the SBIC; only SBA pretends that nothing happens until the SBIC has cash in hand.

NASBIC believes that SBA’s position is erroneous. We understand that SBA is wary of sham transactions where co-conspirators fix inflated prices on small business securities and try to defraud the Government. NASBIC cannot guarantee that unscrupulous people will never try this ruse, but we feel strongly that regulations should be based upon the strength of rational economic policy, rather than solely upon the fear of fraud. Furthermore, we point out that any such deceit already falls under the Federal criminal code. In addition, non-cash gains would not be recognized by SBA until they are specifically certified by an independent accountant.

After studying this subject at length, NASBIC recommends that only debt instruments should be eligible to be recognized for SBA purposes as non-cash gains. The fluctuation of equity prices would raise additional problems.

This revision in present SBA policies is important; the recognition of non-cash gains would bring more money into the SBIC program; it would qualify for additional leverage, and would increase the legal lending limit of all SBICs having such gains.

C. SBA should amend its control regulation.

On at least four occasions during the past 18 years, SBA has revised its regulation dealing with the presumption of control by an SBIC over a portfolio company. At the present time, when the
SBIC and the owner-manager each own 50% of the voting stock, SBA considers that the SBIC is presumed to have control"; in earlier years, such a stand-off was not considered control.

This is a particularly important matter for SBICs which specialize in providing venture capital to new small businesses. In such cases, the SBIC ordinarily provides the bulk of the financing and believes that its interests would be best protected by a 50-50 stock ownership. NASBIC seeks a full SBA review of the present policy and points out that such an amendment to the present regulations would encourage more investments of the very type which SBA itself is seeking.

D. SBA should permit SBICs to augment their private capital structure through the sale of capital notes.

At present, SBICs are allowed to include as private capital only funds raised through the sale of stock. We are certain that some individuals and institutions would be willing to commit dollars to SBICs, but would prefer to purchase SBIC capital notes, rather than stock. Other financial institutions have increased their size through the sale of such notes, and we believe that SBICs should also be given that authority. Under appropriate conditions, subordinated funds raised by SBICs in this manner should qualify for leverage and should be considered in the calculation of a licensee's legal loan limit.

E. Give the SBIC program an Associate Administrator at SBA.

From 1958 through 1972, the SBA official responsible for SBICs was the Associate Administrator for Investment; his duties encompassed only the SBIC and development company programs. Since 1972, that Associate Administrator has been known as the Associate Administrator for Finance and Investment and has been assigned the duties of heading up all of SBA's varied financial assistance programs -- which differ greatly from the SBIC concept. This downgrading of SBICs at SBA has been reflected in the lower priority given urgently-needed revisions in the laws, regulations, and policies relating to our program. NASBIC strongly endorses the assignment of an Associate Administrator responsible only for SBICs; we know that such an official will enable our industry to serve better the small business community.

F. SBICs should be able to invest in Subchapter S firms.

For at least a dozen years, NASBIC has sought statutory authority for SBICs to invest in Subchapter S firms. Now small businesses electing Subchapter S treatment lose that break when an SBIC (or any investor not an individual) purchases its stock. We have found no opposition to the idea, since it would make more firms
eligible for help from SBICs. On the other hand, neither Congress nor the Administration has given a high enough priority to the concept to obtain its passage. They should this year. If SBICs could be shareholders in a Subchapter S corporation, this would redound to the benefit of many small businesses, and would contribute to the health of the SBIC industry as well.

G. Exempt publicly-owned SBICs from the Investment Company Act of 1940.

At one time, there were some 50 SBICs registered under the Investment Company Act of 1940 and these publicly-owned SBICs accounted for the great majority of all private dollars committed to the industry. In 1977, only 14 publicly-traded SBICs are still in business and their private capital is a small fraction of the 1963 total.

NASBIC has spent many thousands of hours and many thousands of dollars trying to gain administrative relief from the '40 Act which would allow venture capital oriented SBICs to operate effectively and efficiently under SEC regulations. We are convinced that no meaningful relief is coming from the Commission, so we strongly urge Congress to exempt publicly-owned SBICs from the strictures of the Investment Company Act of 1940 and combine all necessary regulation of SBICs under SBA.

H. Liberalize Rule 144, so SBICs will be able to cash in on their winners.

Rule 144 is another obstacle to the SBIC-venture capital industry. With the virtual shut-down of the new issues market, most SBICs are able to realize capital gains only through sales of the stock of successful portfolio companies under Rule 144. The current version of that Rule is seriously deficient for SBICs and should be amended in two important respects: first, the volume limitation should be doubled, so SBICs will be able to sell up to 1% of the outstanding stock of the issuer in a three-month, rather than six-month period. The second change would free for sale all the unregistered stock of a qualifying company after the SBIC or venture capital company had held it for five years.

I. Amend Rule 146 so it will be more useful to small firms making private offerings.

The SEC's Rule 146 spelled out the conditions under which a business could sell unregistered stock by utilizing specific criteria of a private offering placement. Although the Rule has clarified a number of points, it has several weaknesses which vitiate its usefulness to small business. NASBIC has recently written the Commission urging amendments to the Rule which would make it more valuable.
IV. GIVING A BETTER BREAK TO SMALL BUSINESS GENERALLY

Up to this point, we have concentrated on those items which would directly benefit the profitability and the operating effectiveness of the SBICs themselves. In this final section of our report, we shall propose a number of recommendations (largely of changes in various laws) which will greatly strengthen the independent sector of our economy and buttress the position of individual small business concerns.

A. Congress should pass the COSIBA Tax Bill.

The Council of Small and Independent Business Associations has drafted a comprehensive tax bill which would significantly lessen the adverse impact of present Federal tax laws on new and small businesses. NASBIC reaffirms its support for all 18 of the provisions of the COSIBA bill, but wishes at this time to stress the particular importance of three features of that measure: (1) the job creation credit which would encourage smaller firms to employ additional workers through a tax credit; (2) a graduated corporate income tax structure which would permit smaller firms to retain a larger portion of their earnings for reinvestment in the business; and (3) a liberalized and simplified depreciation schedule which could be utilized by smaller companies.

B. Present capital gains taxation removes much of the incentive to invest. The trend must be reversed.

The COSIBA tax bill contains a section revising current capital gains taxes, but we believe this item is so important it should be mentioned separately. During the past several years, Congress has skewed the tax laws even more strongly in favor of consumption and borrowing, and against savings and investment. The Nation will inevitably suffer from this short-sighted action, since our productive plant is significantly older than that of other industrialized countries. In addition, the new provisions of law (e.g., the tax on preference income) remove much of the incentive for persons to invest in any business, but particularly in riskier small companies. NASBIC places a high priority on statutory changes which would encourage citizens to invest their dollars in the modernization and expansion of the American industrial plant and in the greater utilization of technological innovation.

C. Executives of small businesses should be allowed qualified stock options.

Under the guise of "loophole-closing", recent amendments to the Internal Revenue Code have removed the attractiveness of restricted stock options for managers of new and small businesses.