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Washington, D. C. 20549
(202) 755-4846

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THE SECURITIES AND EXCHANGE COMMISSION'S
RESPONSE TO THE PROBLEMS OF SMALL BUSINESS

An Address by Harold M. Williams, Chairman
Securities and Exchange Commission

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Small Business
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I. Introduction

I am delighted to have the opportunity to address this regional conference of The White House Conference on Small Business. As President Carter has said, "small business is the essence of our free enterprise economy." Your efforts to enhance public awareness of the important role small businesses play in our economy, and to seek ways to help this sector of American business regain its historic health and vibrancy, are both necessary and appropriate.

After years of apparent neglect, a number of recent initiatives have begun which should contribute to revitalizing small business, and thereby aid our beleaguered economy. We are making progress, and I expect this conference will add measureably to our knowledge about the problems facing small business, and how to solve them.

II. The Importance Of Small Business

Small Business has long been recognized as a vital part of the American economy. The 13 million or so small firms account for 55 percent of all private employment, 48 percent of the nation's business output and 43 percent of its GNP. Even these rather impressive figures fail to convey the full importance of small businesses to the diversity and vitality of our society. Individual efforts to respond to the demands of the free market provide our economy with its immense diversity, achieved to a great extent through the efforts of entrepreneurs of small businesses.

Small business is inherently innovative. It accounts for over half of all industrial inventions and innovation, including such products as the instant camera and power steering.

Small business also creates jobs. The rate of growth in hiring among small, high technology firms, for example, ranges between 24 and 40 percent -- nearly nine times that of employment growth in other sectors of the economy.

In addition, small businesses contribute in no small measure to the foreign exchange earnings of this country.

And small businesses provide individuals with the opportunity to share in the American dream.

But in recent years, small businesses have not flourished. The opportunity cost of capital is high -- as is inflation -- and adverse attitudes towards risk-taking have worked to exclude small companies from our capital markets and impaired their ability to grow. The inability of small business to accumulate capital and generate the savings required for innovation has slowed growth, diminished productivity and contributed to the increasing difficulty in maintaining the standard of living we have come to expect in the United States.

Higher rates of interest mean higher costs of capital. The high cost of capital also causes firms to be under-capitalized or to depend too heavily on short-term debt to finance the enterprise. The result is slower economic growth — particularly for small business.

And, when the demand for capital exceeds supply, not only does the cost increase, but small business -- which is usually at the end of the line -- tends to get left out.

III. The Capital Formation Problems of Small Business

In my view, The unique contribution smaller companies have historically made to our standard of living is in jeopardy unless we develop solutions to their capital formation problems. Let us now look at these problems in greater depth.

A. Problems in Underwriting Small Issues

Small business has always had difficulty in obtaining equity financing. Small companies looking to the public to raise capital often are unattractive to the larger investment bankers, since the amounts they are seeking to raise are too small to be handled profitably by these houses. Many of the costs associated with underwriting a public issue are fixed, regardless of the size of the offering.

The contraction of the brokerage industry since the early 1970's and the growing concentration of larger firms also affects the ability of small business to raise capital. Many of the securities firms that have disappeared through merger and termination are the smaller, local ones that provided a full range of services to local investors and local companies. These local or regional firms brought many local businesses public and provided secondary markets for their securities. Their demise will be felt by small, unseasoned companies seeking to raise needed capital for future growth.

B. The Impact of Inflation

The impact of inflation on capital formation is particularly troublesome. Rising prices and wages require greater outlays of capital to finance investment in plant and equipment as well as operations. Although inflation imposes the same kind of burdens on all businesses regardless of size, those burdens weigh far more heavily on the small business, given its limited means for absorbing the impact of ever-increasing costs and prices. And real profits -- adjusted for inflation -- are not growing at a sufficient rate to meet financing requirements.

Inflation also causes investors to shift their investments from equities to other investments which bear a lower risk and a higher rate of return. Inflation discourages long-term investments and tends to reduce the supply of risk capital. Interest rates rise, and credit becomes increasingly unavailable to smaller businesses. Government spending and the corresponding competition of government with the private sector for available investment capital adds to the capital shortage. A declining rate of savings and investment further exacerbates the situation.

Even steps necessary to bring inflation under control adversely impact small business. For example, the government's anti-inflation policies -- which I fully support -- have necessitated a tightening of credit and a corresponding rise in interest rates. This has not helped small business. As a

House Subcommittee Report on the Future of Small Business has recently stated: "Small Business is not only burdened by the problem of inflation; it is often a hapless victim of the means used to eliminate it."

C. The Impact of Institutional Investors

While federal tax policy has tended to encourage consumption to the detriment of investment, even the savings which do accumulate are channeled away from small enterprise. For example, there is a growing concentration of savings in pension funds, bank trust departments and insurance companies. Indeed, these are our largest pools of investment capital. But concern with liability for risk-taking, and liquidity and resale considerations restrict the ability of these institutions to invest in small concerns. Thus, capital availability to young growing companies, already diminished, is further aggravated by the lack of liquidity, shortened investment horizons and increasingly risk averse behavior of our largest source of investment funds.

If small business is to have access to adequate capital, institutional investment must be increased. Institutions are today best able to direct investment in new offerings to smaller companies and to provide venture capital to those in a developmental stage. Actions need to be undertaken to encourage institutions to respond to the capital needs of this sector of our economy.

D. Tax Policy

Tax policy has a major impact on the ability of small business to attract investment capital. In addition to the effect on savings I mentioned earlier, which impacts the capital available for any investment, small businesses are hit disproportionately hard by tax rate structures tailored to large enterprises, and by an inability to take the same advantage of tax incentives, such as investment credits, as can more capital-intensive larger companies.

E. Federal Regulation

The capital formation problems of emerging companies are further compounded by the burden of government regulation which is often disproportionate and can unfairly impact small business and impair the capital formation process. As regulators, we must be sensitive to the effects our actions have on the allocation of capital among investment opportunities, and try to see that small business capital formation is not unduly disadvantaged.

IV. The Trend Turns

While this litany of problems is long, I am encouraged by a number of recent initiatives which have begun and by the fact that small and medium-sized companies raised over $300 million in initial public offerings during 1978 -- fifty percent more than in 1977, albeit a small amount compared to the $1.7 billion raised in 1972, unadjusted for the impact of inflation. There is a new awareness that small business is in trouble, and some efforts to revitalize small business, and thereby aid our economy, have already been made.

Last year's reform of capital gains taxation, for example, should increase rewards for risk-taking and encourage investment. Although there are other tax matters to be considered -- including the suggestions by Arthur Leavitt, Chairman of this Conference, regarding incentives for the small business investor in equity securities -- the change in capital gains rates is a significant reversal of the long term trend towards disincentives for investment in this country. In addition, the Domestic Policy Review of Industrial Innovation, in which I have personally participated, holds promise for new technological policies designed to enhance the ability of emerging companies to innovate. These initiatives, together with <u>this</u> powerful forum, suggest that the opportunity is at hand to shape the policies which will affect small business for at least the balance of this century.

V. The SEC and Small Business Capital Formation

Many of the problems facing small businesses are beyond the scope of the Securities and Exchange Commission to address. While I have personal thoughts regarding possible solutions for these problems, I would like to spend the rest of my time this morning on those issues related to small business which the Commission can address. Should this conference desire my own views on the broader issues, I would of course be happy to supply them.

A fundamental objective of the federal securities laws is to promote public confidence in the securities markets, so that people will be willing to invest in the vital process by which capital is marshalled from the public and channelled into economic growth. This important interrelationship between investor confidence and capital formation requires that the Commission be sensitive to the effects of its activities on the capital formation process.

The Commission has been cognizant of its role in this regard. While our primary responsibility is to protect investors, we have been able to ease the regulatory burden on small business in a number of areas. Although the Securities Acts are not generally considered to be a primary contributor to the capital formation problems of small business, we do have an impact, and we therefore have a responsibility. We monitor our regulatory actions to ensure that they do not unknowingly affect this sector of the economy. And we have taken affirmative steps, during my tenure as Chairman, to minimize the tension which often accompanies the interaction between small business and the government. I would like to describe some of these initiatives to you. While some will be familiar, others are of quite recent vintage.

A. The Small Business Hearings

In March 1978, the Commission announced a broad scale re-examination of the impact of its regulations on small businesses with an eye toward easing that burden wherever possible consistent with the Commission's statutory responsibilities. A total of 21 days of hearings were held in cities across the country. A diverse group of 170 witnesses, including small businessmen, venture capitalists, lawyers, accountants and state securities administrators appeared at the hearings, and 4,500 pages of testimony were taken.

The Commission recognizes that the small business capital formation problem is exceedingly complex -- we stressed this in our original announcement of the hearings. Many commentators at the hearings reminded us of the relatively small role securities regulation play in this problem. Nevertheless, the importance of small business in our economy obligated us to review our rules to determine if within our statutory authority revisions could be made to further accommodate the needs of small businesses. This review is well along, and in the last year or so has resulted in a number of rule amendments and proposals which we believe are responsive to concerns expressed at our hearings.

B. Rule 144, Regulation A, and Rule 146

Thus, the Commission has amended Rule 144 to more than double the amount of restricted securities which may be sold thereunder and to permit sellers to deal directly with a bona fide market-maker without engaging a broker. In addition, the Commission adopted a further amendment to the Rule which would remove the volume restrictions entirely -- after a certain holding period -- for persons not in control of the issuer.

The Commission has also endeavored to make offerings under Regulation A and Rule 146 more viable for small business. Thus, Regulation A was amended to increase the amount of securities which may be sold thereunder within a 12-month period from $500,000 to $1,500,000. Early returns indicate that both the number and size of Regulation A offerings have increased significantly. In addition, the Commission expects to act quickly on a proposed amendment which would permit the use of pre-selling documents in Regulation A firm commitment underwritings. In addition to raising the Regulation A ceiling, the Commission also amended Rule 146 to permit the use of Regulation A-type disclosure to satisfy the Rule's information requirement for offerings which do not exceed $1,500,000.

C. Form S-18

Just this past week, the Commission took a significant step expressly designed to assist small business capital formation. We adopted a new registration form, called S-18. Because of the limitations of Regulation A, there was a need for a simplified and less costly form for the registered offering of securities by small businesses. Until now, there were many smaller, non-reporting companies who sought to raise capital through the public offering of securities, for whom Regulation A was not a meaningful alternative. They had to comply with the requirements of Form S-1, the Commission's most elaborate and most costly registration form. In order to bridge the gap between Regulation A and Form S-1, the Commission adopted Form S-18 and corresponding amendments to annual report Form 10-K. The simplified registration and reporting procedures which Form S-18 reflects were strongly endorsed by the witnesses at the hearings.

Using Form S-18 and the amendments to Form 10-K, a small unseasoned issuer may sell up to $5 million in equity securities to the public without immediately incurring the full range of disclosure and reporting requirements -- and the resulting costs -- imposed upon other issuers. In addition, to provide some liquidity to early investors and venture capitalists, the form also allows them to sell up to $1.5 million of stock they own in the company. We anticipate use of this form will significantly reduce legal and accounting costs and may allow small issuers to keep their local accounting firms when going public for the first time.

In order to make meaningful the relief from normal requirements provided by Form S-18, we also amended Form 10-K to allow a company utilizing Form S-18 to include in its first annual report narrative and financial information substantially similar to that included in its Form S-18 prospectus.

In connection with the utilization of Form S-18, specific registrants will have the option of filing their registration statement either at the Commission's principal office in Washington or at one of the Commission's nine Regional Offices. Regional processing may result in less costly and more timely access to the capital markets for small businesses. Many commentators at the hearings felt that the familiarity of Regional Office personnel with a small issuer's operations and local market conditions would expedite the review process. Also, the geographical accessability of Regional Offices was thought -- especially by witnesses in the West -- to save costs associated with trips to Washington for pre-filing and other conferences.

At this time we do not know precisely how many issuers will utilize Form S-18; but, based on the response received at the Small Business Hearings, we are optimistic. The Commission is especially encouraged by the support for Form S-18 exhibited by the regional underwriting community. We are hopeful that the Form will serve to increase their involvement in the small business capital formation process.

D. The Office Of Small Business Policy

While I am hopeful that the changes we have made will be of substantial assistance to small businesses, I am mindful that they are not a panacea for the entire universe of small enterprises. In many respects, these initiatives address themselves primarily to the strongest group of firms in the small business community -- those firms who are at the stage and size where they begin to command a public market for their securities. For this reason, the peculiar requirements of fledgling enterprises may require more substantive and constant attention at the Commission.

As a practical matter, the recurring and pervasive nature of many of the problems which the securities laws present for small business have caused the Commission to consider establishing a more permanent organizational unit to deal with them. I am therefore today announcing the establishment of the Office of Small Business Policy within the Division of Corporation Finance. This Office will be the focal point for small business matters within the Division.

The functions of the Small Business Office will include developing and assisting in the development of rules and regulations designed to assist and ease capital formation; providing expertise in monitoring and interpreting rules and regulations; and providing liaison with Congress, other agencies and groups concerned with the problems of small businesses, as well as dealing directly with small businesses themselves.

The office will process Form S-18 registration statements filed in Washington and will monitor the processing of offerings on Form S-18 filed in the Regional Offices. It will also direct its attention to three significant projects resulting from the Small Business Hearings. These are (1) the development of a special exemption from registration for small businesses under Section 3(b) of the Securities Act as an alternative to the private placement exemption provided by Rule 146; (2) the reduction of disclosure requirements under the 1934 Act by classifying issuers according to size or other suitable criteria; and (3) increased cooperation between federal and state securities regulatory authorities, especially in the area of exemptions from registration. Ed Greene, the new Director of the Division of Corporation Finance, has assured me that these efforts will receive the highest priority.

I believe that this unified approach will heighten the Commission's sensitivity to the problems of small business, and will go a long way toward removing much of the frustration that accompanies dealings by small businesses with the SEC.

VI. Conclusion

The Commission is cognizant of the problems presently facing small businesses. As I stressed earlier, in many respects the problems of small business are rooted in broader economic factors which cannot be remedied by amending the Commission's rules and regulations. Nevertheless, the Commission has made a strong commitment to easing the impact of the federal securities laws on small firms whenever possible consistent with our primary mandate to protect the investing public. I am hopeful that the Commission, working closely with the private sector, can devise imaginative approaches which will fulfill both of these goals. I invite your active cooperation and support in the tasks that lie before us.

Thank you.