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Statement on

H. R. 12666, to Amend the "Small Business Investment Act of 1958"

Presented to

Subcommittee on Capital, Investment and Business
Opportunities of the House Committee on Small Business
United States House of Representatives

by

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I welcome the opportunity to appear before the Subcommittee on Capital, Investment and Business Opportunities of the Committee on Small Business of the House of Representatives to testify on H. R. 12666, a bill to amend the Small Business Investment Act of 1958.

Mr. Chairman, as you have stated, the purpose of H. R. 12666 is to make institutional funds more readily available to small business concerns by removing existing legislative and administrative impediments preventing large financial institutions from making equity investments in small businesses. The bill would accomplish this objective by preempting any State or Federal law, rule or regulation to the contrary and by expressly authorizing investments in the equity of small business concerns up to an aggregate investment in all such concerns of 5 percent of the investing institution's net worth. Also, the bill prohibits any institution from acquiring direct or indirect control of any small business concern in which it has an equity investment and provides that such investments shall not violate State or Federal law prescribing fiduciary conduct if the institution reasonably believed at the time it made the investment that the potential gain from such investment justified the acquisition.

Evidence indicates that small businesses are having difficulty in attracting equity investments. The nature of the problem is described in the January 1977 Report of the SBA Task Force on Venture and Equity Capital for Small Businesses. The Report reveals that the amount of equity financing for companies having a net worth of $5 million or less declined from $1.5 billion in 1969 to $16.2 million in 1975. "Today, most underwriting is by the 'majors,' and these 'majors' will not generally underwrite companies with annual earnings of less than $2 million. The few remaining strong regional brokers are working almost exclusively with firms whose earnings are between $1 million and $2 million."

Based on this Report, it appears that equity investment in small businesses has become seriously inadequate.

We support the goal of H. R. 12666 to provide additional equity capital to small business concerns. The health and viability of small business concerns throughout the country are essential to the preservation of our competitive free enterprise system and to the strength of our economy. However, we would be less than candid if we did not express some doubt that H. R. 12666 will have a significant impact in encouraging banks to invest in the equity of small business concerns.

Historically banks have not been permitted to engage in the type of direct equity funding permitted under H. R. 12666. As pointed out by the House Banking and Currency Committee in the House Report on the Small Business Investment Company Act of 1958 (House Report No. 2060, June 30, 1958, p. 3680):

> ...When these institutions [commercial banks] exert judgment in the matter of making investments it is found they prefer investing their funds in those securities which have active national markets. Information available to the Committee indicates that institutional investors have shown little desire to invest in small concerns on a long-term basis and it is unlikely that their investment policies will change in this respect.

That assessment, in my judgment, has not changed. At the same time, we believe that the bill will have some beneficial impact and we favor its enactment.

Although we support the concept embodied in H. R. 12666, it might be more effective to develop in tandem with this legislation incentives which will make investments in small businesses more attractive. For example, some tax advantages are already in place and available to institutions and persons that invest in small businesses. It might be possible to develop additional tax advantages. Other avenues that might be explored both on the statutory and administrative side include the alleviation of the expense and other burdens of raising capital to small business concerns associated

with the requirements of the securities laws and regulations, the exemption of small businesses from compliance with certain burdensome and costly Federal regulations, and the development of better secondary markets for the equity securities of small business firms.

We recommend certain language changes in H. R. 12666 which we believe would deal with the difficulties embodied in this legislation. As you know, under the Small Business Investment Company Act (15 U.S.C. Section 682(b)), national and State banks, provided State law permits, may invest up to 5 percent of their capital and surplus in the stock of small business investment companies which, in turn, are authorized to make equity investments in small business concerns. It is not clear whether Section 601(a) authorizes equity investments in small businesses equivalent to 5 percent of the bank's net worth in addition to the statutory authority that banks presently have to invest indirectly in the equity of small business concerns up to 5 percent of their capital and surplus through the vehicle of a small business investment company. We recommend that this ambiguity be removed by clarifying whether an overall 5 percent aggregation limit or separate 5 percent limits aggregating 10 percent is intended. We have no objection to separate 5 percent limits.

Under Title III of the Small Business Investment Act of 1958 (15 U.S.C. 682), the 5 percent limit is geared to the "capital and surplus" of the investor. On the other hand, the 5 percent limit under the bill is related to the "net worth" of the investor. We recognize that the term "net worth" is defined under the bill; however, the phrase "capital and surplus" and the phrase "net worth" are not synonymous in their meaning. "Net worth" may include undivided profits and unallocated reserves, while the phrase "capital and surplus" ordinarily does not. We, therefore, suggest that either the bill be amended to delete the phrase "net worth" and substitute in its place the

phrase "capital and surplus" or that 15 U.S.C. 682 (b) (1) be amended by deleting the phrase "capital and surplus" and substituting in its place the phrase "net worth" together with the same definition contained in H. R. 12666.

We are concerned that the phrase "Notwithstanding any provision of State or Federal law, rule or regulation to the contrary," appearing in Section 601(a) of the bill may be overly broad. Literally read, this Section could be viewed as negating all Federal law relating to safe and sound banking practices. Arguably the language of this Section might proscribe the Federal bank regulatory agencies from proceeding with their remedial cease and desist powers to correct unsafe or unsound investments by banks in small business concerns. We recommend, therefore, that the methodology employed in 15 U.S.C. 682(b) be employed in Section 601(a) of the bill and that the Section or Sections of the Federal law affected by the bill be specified. Alternatively, the Committee report of the bill could clarify that it is not intended to negate any laws other than those that prohibit investments in equity capital of small business concerns.

In addition, 15 U.S.C. 682(b) follows the approach of allowing funding of equity capital of small business investment companies as eligible investments for State chartered banks to the extent permitted under applicable State law. We believe that approach is preferable to the preemption of State law.

We recommend that the word "control" appearing on line 12 of page 2 of the bill be defined. Unless defined with some precision, the use of the word "control" may create questions of fact which could prove difficult to resolve.

We also recommend that all of Section 601(b) be deleted from the bill because its meaning and intent are not clear. There is the danger that

Section 601(b) may be construed as completely overruling the prudent person rule under ERISA and under the common law with respect to equity investments in small business concerns by institutional investors. We note the proposed rule making action by the Labor Department (43 F.R. 17480, April 25, 1978), which would make it clear that the prudent person rule applies to the entire investment portfolio and not to individual investments in the portfolio. Such a regulation would obviate construing pension plan investments in small business concerns as inherently imprudent and, as a result, such investments could be considered prudent under the provision of ERISA.

Finally, we suggest that Section 601(c) of the bill be amended to ensure that the Federal bank regulatory agencies have enforcement authority over the banks which they directly supervise with respect to any regulations issued by the Administrator of the Small Business Administration. The provision under 601(c) of the bill could be amended along the lines adopted in the Truth-in-Lending Act (15 U.S.C. Section 1607 (a) (1)), as follows:

> Compliance with the requirements imposed under this Section shall be enforced under section 8 of the Federal Deposit Insurance Act, in the case of:
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> (a) National banks, by the Comptroller of the Currency.
>
> (b) Member banks of the Federal Reserve System (other than National banks) by the Board of Governors of the Federal Reserve System.
>
> (c) Banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), by the Board of the Directors of the Federal Deposit Insurance Corporation.

Mr. Chairman, I would like to thank you and this Subcommittee for inviting the FDIC to testify on H. R. 12666. We are concerned about developing ways of meeting the capital needs of small businesses and stand ready to work with you and this Subcommittee in achieving this objective.