THE SMALL BUSINESS INVESTMENT COMPANY: 
AN ATTEMPT TO FILL THE EQUITY GAP

I. 
INTRODUCTION

For the purpose of this comment a “small business” is defined as a company that, together with its affiliates, is independently owned and operated, is not dominant in its field, does not have assets exceeding five million dollars, net worth exceeding two and a half million dollars, or average net income during its last two years exceeding two hundred and fifty thousand dollars.\(^1\) As of January 1, 1962, there were approximately 4,478,000 of these concerns in operation.\(^2\) Such enterprises must have access to ready capital and long-term financing to enable them to grow with our country's expanding economy.\(^3\) Unlike most concerns, small businesses have not had access to adequate financing.\(^4\) The small enterprise in such a predicament becomes trapped in the “equity gap,”\(^5\) that is, an area where it finds the commercial banker unwilling to make long-term loans, and where size precludes it from obtaining reasonably priced equity capital through the public sale of securities.\(^6\) The federal government sought to remedy this situation. In 1958 legislation was passed which authorized the creation of Small Business Investment Companies:\(^7\) corporations which were to be licensed by a government agency for the express purpose of supplying long-term financing and capital to small businesses.\(^8\) A brief review of the prior attempts to fill the equity gap will demonstrate the necessity of the 1958 legislation creating the SBIC.

Until 1932 there appeared to be no adequate source of funds at reasonable rates, for “growth businesses” too small to appeal to private investors or bankers.\(^9\) During 1932 the Reconstruction Finance Corporation was formed to aid in financing commerce and to encourage small business through the purchasing of obligations and the making of loans to any

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1. 13 C.F.R. § 121.3-11(a) (1962). This definition is taken from the regulations issued by the Small Business Administration, and is the one used to define a small business for the purpose of receiving financial assistance from a Small Business Investment Company. In subsection (b), the regulation gives alternative size criteria based mainly on the number of employees, or the volume of sales, should the small business be unable to meet subsection (a)’s standards.

2. 2 CCH Corp. Law Guide ¶ 11449 (1963).


4. Ibid.

5. 2 CCH Corp. Law Guide ¶ 11585 (1963) would say such a small business is caught in the “financial gap” which is “a lack of long-term financing for small firms in their beginning and rapid growth stages when private investors are hard to find and commercial banks hard to interest.”

6. SBA Fact Sheet No. 2, Small Business Investment Companies (March 1962).


business enterprise organized or operating under the laws of any state or
the United States. However, the life of the Finance Corporation was
limited by statute, and since 1949 its functions have gradually been
transferred to other governmental agencies. In 1950, at the President’s
request, Congress undertook to review the needs of small business. The
Korean War halted any action until 1953 at which time the Small
Business Act was passed.

The Small Business Administration, established by the Small Busi-
ness Act, was authorized to make direct loans to small enterprises, but
this did not quite span the equity gap because from 1953 to 1958 Con-
gress considered various other methods designed to meet the problem,
none of which were adopted. The government wanted a program which
could help small businesses without direct federal intervention. In 1958,
the Administrator of the SBA indicated to the Senate the various principles
which should govern any legislation designed to fill the equity gap. His
principal recommendation called for participation by profit-oriented private
capital and private organizations to give impetus and continuity to the
program. The Administrator’s suggestions formed the basis for a new
financing program which was codified as the Small Business Investment
Act of 1958. The policy and purpose of this act is explained in section
102:

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

11. Ibid.
§ 601 n. (1958) transferred the duties of the Reconstruction Finance Corporation
and abolished it in 1957.
14. McCallum & Davis, Small Business Investment Companies—An Experiment
16. Hereinafter cited as SBA.
18. McCallum & Davis, supra note 14, at 296. The most seriously considered idea
was a nationwide network of capital banks under the supervision of the Federal
19. McCallum & Davis, supra note 14, at 296-97, citing Senate Banking and
Currency Committee, Hearings, Financing Small Business, 85th Cong., 2d Sess. 82-88
(1958).
early impressions of the SBI Act. Current legislation limits the SBA to an aggregate of three hundred and forty-one million dollars for the exercise of functions
The act contains the following limitations on the above policy: that it "be carried out in such manner as to insure the maximum participation of private financing sources," and that the "provisions of this chapter shall be so administered that any financial assistance provided hereunder shall not result in a substantial increase of unemployment in any area of the country."

Because of insufficient legislative benefits, initial interest in the act died by 1960, and in an attempt to remedy this situation legislative changes in the SBIC program were made in 1960 and 1961. The net result was a surge of growth and activity up to the Spring of 1963.

Once again though, interest in the program seems to lag as evidenced by the declining market value of SBIC stock and the decreasing number of SBIC's currently being licensed. Public issuance of shares, the greatest source of capital for an SBIC, is difficult to carry out with current depressed market values of SBIC stock. Various amendments to the SBI Act have been suggested to increase interest in forming and buying shares of SBIC's. The following sections will consider these amendments, how they relate to the formation and operation of an SBIC and how

23. Ibid.
24. Ibid. Query how moving of a small business could result in substantial increase in unemployment?
27. The most important changes will: (1) permit the SBIC to use forms of equity securities other than convertible debentures in providing equity capital for small businesses, 74 Stat. 196 (1960), 15 U.S.C. § 684 (Supp. 1963), redesignating subsection (c) as (b), and eliminating former subsection (b) which required capital to be secured only through the purchase of debenture bonds; (2) increase the maximum amount of subordinated debentures the SBIC may sell to the SBA from one hundred and fifty thousand dollars to four hundred thousand dollars, SBI Act § 362(a), 75 Stat. 752 (1961), 15 U.S.C. § 682(a) (Supp. 1963); (3) relieve the small businesses from purchasing stock in the SBIC from which they obtained financing, SBI Act § 304(c), 74 Stat. 196 (1960), 15 U.S.C. § 684(c) (Supp. 1963); (4) increase from one to two per cent of capital and surplus the permissible investment in SBIC's by banks, SBI Act § 302(b), 75 Stat. 752 (1961), 15 U.S.C. § 682(b) (Supp. 1963).
28. As of September 13, 1963, there were 709 licensed SBIC's and over 7,000 transactions by SBIC's with small businesses for loans of three hundred and eighty million dollars. Letter from Paul T. Jantzen, Chief, Investment Division, Philadelphia Region SBA to C. Dale McClain, October 30, 1963, on file with VILLANOVA LAW REVIEW [hereinafter cited as Letter from Paul T. Jantzen]. It is interesting to note that approximately eighty-five per cent of the funds available for loans come from private investment, and that there is an SBIC in forty-three states and most territories. S. Rep. No. 161, 88th Cong., 1st Sess. 2 (1963).
29. S. Rep. No. 161, 88th Cong., 1st Sess. 13 (1963) [hereinafter cited as SENATE REPORT], cites the following factors as reasons for the decline: SBIC stock was originally considered to be a glamor stock, general market conditions, and the loss of public confidence.
30. There are currently approximately five new SBIC's being formed each month. Letter from Paul T. Jantzen.
31. SENATE REPORT 13. Another source of capital for SBIC's is by a merger. The SBA recently approved the merger of two Wisconsin SBIC's. 2 CCH CORP. LAW GUIDE ¶ 11583 (1963).
32. 2 CCH CORP. LAW GUIDE ¶ 11584 (1963).
they will increase participation in the program thereby diminishing the equity gap.

Throughout this comment it will be necessary to keep two basic relationships in mind: the relationship between the SBA and the SBIC and the relationship between the SBIC and the small business which seeks its assistance. Only by recognizing these two levels of activity can one appreciate and understand the government's present approach to aiding the small enterprise.

II.

FORMATION OF AN SBIC

The SBI Act establishes a division in the SBA known as the Small Business Investment Division\textsuperscript{33} headed by a Deputy Administrator.\textsuperscript{34} The Deputy Administrator will issue a license to operate an SBIC\textsuperscript{35} to companies which have met the statutory requirements by filing a proposal, securing a state charter, and establishing minimum capitalization of at least three hundred thousand dollars.

A. Filing a Proposal

The first step in securing a license is submission of a proposal through a regional office of the SBA.\textsuperscript{36} The proposal consists of three parts: a plan of operations, a summary of the operators' experience and a financial statement of each proposed officer, director, and stockholder of ten or more per cent\textsuperscript{37}—although the latter need only be completed where the proposed SBIC is also requesting SBA funds.\textsuperscript{38} In passing on a proposal the Administrator must give due regard "to the need for the financing of small-business, the general character of the proposed management of the company, the number of such companies previously organized in the United States, and the volume of their operations."\textsuperscript{39}

B. Securing a Charter

Although the SBIC need not be incorporated when it submits its proposal, a copy of the proposed charter under which the SBIC is going to operate must be submitted with the proposal.\textsuperscript{40} The charter must spe-

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\item \textsuperscript{33} Hereinafter cited as SBI Division.
\item \textsuperscript{35} SBI Act § 301(c), 72 Stat. 691 (1958), 15 U.S.C. § 681(c) (1958).
\item \textsuperscript{36} 13 C.F.R. § 107.102 (1962). Copies of SBA Form 414—Proposal to Operate a Small Business Investment Company—and a list of regional offices of SBI Division are available at the office of the Deputy Administrator, Investment Division, Small Business Administration, 811 Vermont Avenue N.W., Washington 25, D.C. There is a collection of all necessary forms, and an explanation of them, in 1 CCH Corp. Law Guide ¶ 3905-60 (1963).
\item \textsuperscript{37} 13 C.F.R. § 107.102 (1962).
\item \textsuperscript{38} Ibid.
\item \textsuperscript{39} SBI Act § 301(c), 72 Stat. 691 (1958), 15 U.S.C. § 681(c) (1958).
\item \textsuperscript{40} Ibid.
\end{itemize}
cifically state that the corporation is organized expressly to operate under the SBI Act and will be subject to the regulations of the SBA.\textsuperscript{41} The charter must specify the life of the corporation, which may not be less than thirty years,\textsuperscript{42} and the classes of shares of capital stock.\textsuperscript{43} In addition, the charter must designate the area of operations,\textsuperscript{44} as well as the establishment of any branch offices, both of which are subject to the approval of the SBA.\textsuperscript{45} If the proposal and the proposed charter are accepted by the Administrator, the persons seeking to operate the SBIC must then incorporate it under state law.\textsuperscript{46}

C. Establishing the Minimum Capitalization

The final statutory requirement for obtaining a license to operate as an SBIC is securing the necessary minimum capital of three hundred thousand dollars,\textsuperscript{47} which the regulations issued by the SBA require to be in the form of cash or direct obligations of, or obligations guaranteed as to principal and interest by, the United States.\textsuperscript{48} The minimum capital is generally acquired by the sale of capital stock\textsuperscript{49} to the public or the sale of subordinated debentures to the SBA.\textsuperscript{50} The subordinated debentures are long-term obligations secured only by the general credit of the SBIC.\textsuperscript{51} Minimum capitalization can be met with one hundred and fifty thousand dollars of the SBIC's own capital procured from the sale of stock and one hundred and fifty thousand dollars from the proceeds of subordinated debentures purchased by the SBA.\textsuperscript{52} Once the necessary minimum capital has been secured a license will be issued to the SBIC.\textsuperscript{53}

D. Securing Additional Operating Capital

After the SBIC begins operations and has secured its minimum capital, it may seek additional funds. There are four basic sources from

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\item \textsuperscript{41} 13 C.F.R. § 107.104 (1962). The SBA is authorized to prescribe regulations to carry out the provisions of the act and govern the operations of the SBIC's. SBI Act § 308(c), 72 Stat. 691 (1958), 15 U.S.C. § 681(c) (1958). Note that the regulations of the SBA have the force of law. Hernstadt v. Programs for Television, Inc., 232 N.Y.S.2d 683 (N.Y. City Ct. 1962).
\item \textsuperscript{43} SBI Act § 301(b), 72 Stat. 691 (1958), 15 U.S.C. § 681 (b) (1958).
\item \textsuperscript{44} SBI Act § 301(b), 75 Stat. 756 (1961), 15 U.S.C. § 681 (a) (Supp. 1963).
\item \textsuperscript{45} Ibid.
\item \textsuperscript{46} Ibid. Original provisions in the act providing for federal charters expired on June 30, 1961. SBI Act § 301(a), 72 Stat. 691 (1958). These provisions were deleted by 75 Stat. 756 (1961). Since its inception, the Act has permitted banks to invest in stocks of, and form SBIC's, limiting such investment to a certain percentage of the banks' capital and surplus. SBI Act § 302(b), 75 Stat. 752 (1961), 15 U.S.C. § 682(b) (Supp. 1963). The current limitation is two per cent of the banks capital and surplus, previously it was one per cent.
\item \textsuperscript{48} 13 C.F.R. § 107.302(a) (1962).
\item \textsuperscript{50} Ibid.
\item \textsuperscript{51} The SBIC, Small Business Administration (April 1962). 13 C.F.R. § 107.301(g) (1962), states that such subordinated debentures shall bear interest at the rate of five per cent.
\item \textsuperscript{53} SBI Act § 301(c), 72 Stat. 691 (1958), 15 U.S.C. § 681(c) (1958).
\end{itemize}
which additional operating capital may be secured: by the sale of capital stock, by private loans, by issuing subordinated debentures or, obtaining straight loans from the government. When the sale of capital stock is for the purpose of meeting the minimum capitalization requirements it must be issued for cash or guaranteed government securities, but the regulations permit capital stock that is not required for the minimum capitalization to be issued for cash, securities, services, physical assets, as a dividend, or in connection with a statutory merger or consolidation with another SBIC. The public sale of capital stock of established SBIC's during the past three years has been the reason for the substantial increase in money invested in the SBIC program.

An SBIC is permitted to borrow from private sources, but the SBA regulations limit the ratio of the total indebtedness to paid-in capital and surplus to four to one. To encourage private institutions to loan money to SBIC's, the SBA established the practice of guaranteeing such loans up to fifty per cent of the capital and surplus of the SBIC or four million dollars, whichever is smaller. If the SBIC is unable to secure private loans at reasonable rates, present legislation enables the SBIC to obtain such loans directly from the SBA. These loans are limited to fifty per cent of the paid-in capital and surplus of such company or four million dollars, whichever is smaller. Subordinated debentures sold to the SBA are considered a part of capital for purposes of computing paid-in capital and surplus. The act limits the sale of these debentures to the SBA in that they may be sold only during the first three years of the SBIC's operations. The act also provides that the SBA may purchase up to four hundred thousand dollars of the SBIC's subordinated debentures, provided there is paid-in capital and surplus from all other sources at least equal to that amount. The four hundred thousand dollar maxi-

59. Ibid.
60. Letter from Paul T. Jantzen.
63. Senate Report 8.
64. SBI Act § 303(b), 75 Stat. 752 (1961), 15 U.S.C. § 683(b) (Supp. 1963). The SBA regulations state that such funds are deemed available from private sources, unless the licensee can show proof of refusal from the licensee's local bank, or that the loan is in excess of the legal lending limit of the licensee's bank, or refusal from not less than two banks in cities where the population exceeds 200,000. 13 C.F.R. § 107.402(b) (1962). The regulations also state that such loans may be prepaid at any time, but in every event the loans shall be at the rate of five per cent with maturities not to exceed twenty years. 13 C.F.R. § 107.402(c) (1962).
mum includes any debentures purchased by the SBA to aid the SBIC in establishing its minimum capital required by the Act.

Under present legislation if the SBIC has four hundred thousand dollars from the sale of capital stock the maximum amount of government financial aid that it may secure is eight hundred thousand dollars. This figure is computed as follows: the SBIC may sell four hundred thousand dollars of subordinated debentures to the SBA, and the SBIC may receive a loan of four hundred thousand dollars from the SBA or four hundred thousand dollars from a private loan guaranteed by the SBA. The four hundred thousand dollar loan is derived by applying the fifty per cent of capital and surplus limitation to the proceeds of the sale of capital stock (fifty per cent of four hundred thousand dollars) and the sale of subordinated debentures (fifty per cent of four hundred thousand dollars).

It is readily seen that the maximum leverage (leverage in the sense of using the government assistance from both subordinated debentures and loans) under the Act would be one million two hundred thousand dollars: four hundred thousand dollars from capital stock and eight hundred thousand dollars from the government. An SBIC must therefore be expected to operate independently and profitably with this sum of money invested in income-producing securities.

The one million two hundred thousand dollar maximum is based on the theory that the SBIC involves passive management, and no larger sum is needed, but the contrary has proven true. Industry representatives, report that more than fifty per cent of the employees' time must be spent in working with portfolio companies of the SBIC. It has therefore been necessary to have more employees than was initially expected, and it is now anticipated that an SBIC needs between two and one-half and five million dollars in total funds in order to operate profitably and provide maximum service to the small businesses which it finances.

Since approximately ninety per cent of the SBIC's currently licensed have capital and surplus of less than one million dollars, it would appear that either these companies are operating marginally or are not devoting as much time as they should to their portfolio companies. It is with this in mind that new legislation has been introduced which will give SBIC's an incentive to increase their capital.

71. In fact members of Congress in 1960, expected SBIC's to be able to operate profitably and independently on between one and five million dollars in income producing securities. Senate Report 3.
72. Id. at 4.
73. Id. at 3.
74. Ibid.
75. Senate Report 19.
76. This could also explain the decline in interest in the program and depression of market values of SBIC stock.
77. Senate Report 5.
tion would increase from four hundred thousand to one million dollars, the amount of subordinated debentures the SBA may purchase, give statutory authority to the SBA’s standby program increasing the guarantee of private loans to one hundred per cent of capital and surplus or eight million dollars, whichever is smaller. Under this new program the maximum leverage under the Act, assuming a sale of capital stock of one million dollars and a purchase by the SBA of one million dollars worth of subordinated debentures, would be four million dollars, computed as follows: one million dollars from the sale of capital stock, one million dollars from subordinated debentures, and two million dollars from a private loan guaranteed by the SBA. The additional leverage would enable most SBIC’s to achieve financial independence while providing full services to the small businesses they finance.

III.

OPERATING UNDER THE SBI ACT

A. Eliminating the Equity Gap: The Small Business and the SBIC

A small business should seek the aid of an SBIC when it finds itself trapped in the equity gap and also desires to make use of an SBIC’s management advice. The SBIC may provide financial assistance to the small business in the form of long-term loans, or purchase of equity securities, such as stock or convertible debentures. The first step is for the small business to secure the assistance of counsel since there will be technical instruments to be completed when negotiations with the SBIC commence. The small business should appraise its actual monetary needs, and ascertain what SBIC’s are available in its area by inquiring at the regional SBA office. A small business should not be persuaded by the financial terms offered by a particular SBIC because the differences between SBIC’s in this respect are usually minor. It is most important that an SBIC be chosen that has good management advisory services as well as funds to lend.

Not all small businesses are able to make use of SBIC financing. The SBA regulations specifically prohibit financial assistance to agricultural activities, professional associations, and business concerns which derive

82. Stewart, supra note 79, at 399. This same article contains a check-list for negotiating with SBIC’s. Id. at 396. It is advisable to make such a list to aid in reviewing the terms of the agreement with the SBIC.
83. Stewart, supra note 79, at 400.
84. Id. at 399.
a substantial portion of their sales from the sale of alcoholic beverages. Furthermore, the small business is restricted in its use of SBIC funds. The regulations prohibit the use of the funds by the small business for relending, for purposes contrary to public policy, for use outside the United States, and for financing land speculations.

The Act specifically states that it is a function of the SBIC to provide a source of equity capital for incorporated small businesses. The SBA regulations define equity capital as funds received by a small business for the issuance of equity securities. Equity securities are defined by the regulations to be certificates of stock of any class, or instruments which evidence a debt and provide a conversion privilege. If the SBIC does supply equity capital to a small business, it may require the small business to refinance its outstanding obligations so that the SBIC is the only holder of indebtedness. The SBIC may also require the opportunity to approve and finance new indebtedness. In any event the SBIC is limited in that it cannot supply equity financing for a period of less than five years.

The SBA has issued detailed regulations concerning the issuance of convertible debentures and their conversion. In essence these provisions require that the debentures be convertible into stock at the sound book value of the stock which is determined when the debentures are issued. The debentures cannot be issued for less than five years, but they may be repaid on any interest date with three months notice, and they remain convertible up to the date of payment.

Initially, if an SBIC supplied equity capital to a small business, the business was required to purchase a certain percentage of the capital stock of the SBIC. This requirement was found to deter financing under the program, and in 1961 the purchase of SBIC stock was made optional on the part of the financed small business.

An SBIC is permitted to make long-term loans to incorporated or unincorporated small businesses for the purpose of supplying funds for sound financing, growth, modernization, and expansion. The act states that such loans shall have a maturity not exceeding twenty years.

89. Ibid.
90. Ibid.
91. Ibid.
96. Ibid.
99. Ibid.
103. SBI Act § 305(d), 72 Stat. 693 (1958), 15 U.S.C. § 685(d) (1958). Subsection (f) states that the SBIC is "authorized to extend the maturity of or renew Published by Villanova University Charles Widger School of Law Digital Repository, 1963
regulations do permit loans with maturities of less than five years where the loan is necessary to protect the SBIC’s interest in previously issued equity securities or long-term loans. Furthermore an SBIC may join with other investors in supplying equity capital and long-term loans to small businesses.

B. Additional Limitations on the Operation of an SBIC

The most troublesome limitation faced by an SBIC is the amount of assistance it may render to any single enterprise. Originally the Act provided that an SBIC could not invest more than twenty per cent of its own capital and surplus in one business. However, in 1961, an additional provision was written into the Act limiting investment in any one small business to five hundred thousand dollars under the assumption that a firm requiring more than that amount was not a small business. The five hundred thousand dollar limitation has been severely criticized. The Administrator of the SBA testified that it is questionable “to equate size of loans with size of company.” The Senate Select Committee on Small Business concurred and cited in its report examples of cases where loans over five hundred thousand dollars were made to businesses that were actually “small businesses.” The proponents of the five hundred thousand dollar limitation point to the SBA regulations which permit as many as five SBIC’s to participate in making a loan. Theoretically with each SBIC contributing five hundred thousand dollars there could be two and one-half million dollars available to the small business. The Senate Committee maintains that it is unreasonably burdensome to require some small businesses to deal with five SBIC’s while others may have to deal with only one. Accordingly, there is legislation now before both Houses of Congress which would remove the five hundred thousand dollar limitation.

such loan for additional periods, not exceeding ten years, if the company finds that such extension or renewal will aid in the orderly liquidation of such loan."

But these participants are also bound by the regulations of the SBA. Hernstadt v. Programs for Television, Inc., 232 N.Y.S.2d 683 (N.Y. City Ct. 1962).
106. SENATE REPORT 16.
109. SENATE REPORT 17.
110. Some parties contend that the limitation is responsible for the decline in SBIC market values, and others say it limits long-term gains. SENATE REPORT p. 16.
112. SENATE REPORT 18.
113. Id. at 20.
115. SENATE REPORT 20. The committee in speaking of the five hundred thousand dollar limitation concludes that: “. . . this limitation will impede the flow of capital and credit to deserving small businesses, that it is not needed, and that its continuation as a part of the statute is not in the best interest of the American small business community.”
Two other limitations warrant comment. First, the SBA regulations limit to five the number of SBIC's that may participate in providing equity capital or long-term loans to a single enterprise.\textsuperscript{117} This limitation appears reasonable because it is unwise for a small business to become involved with more creditors than is absolutely necessary. The second limitation relates to the use of idle operating funds. The regulations were recently and wisely amended to stipulate that money not invested be placed with a bank which is a member of the Federal Deposit Insurance Corporation either on time deposit, limited to one year, or on demand deposit.\textsuperscript{118} The regulations had previously limited time deposits to six months.\textsuperscript{119}

\section*{C. Regulation of the SBIC by the Securities and Exchange Commission}

The SBIC may, in addition to the limitations imposed by the SBA, be subject to regulation by the Securities and Exchange Commission\textsuperscript{120} through the Securities Act of 1933,\textsuperscript{121} the Trust Indenture Act of 1939,\textsuperscript{122} or the Investment Company Act of 1940.\textsuperscript{123} This dual system of regulation has been severely criticized,\textsuperscript{124} but it appears necessary because of the differences in the scope of activities and purposes of the two organizations.\textsuperscript{125}

The Securities Act of 1933 provides that an issuer\textsuperscript{126} of a security\textsuperscript{127} in excess of three hundred thousand dollars\textsuperscript{128} must file a registration statement with the SEC prior to a public offer to sell the security through interstate commerce or the mails.\textsuperscript{129} The purpose of the act is to require disclosure of financial and other material information in order to prevent fraud and misrepresentation.\textsuperscript{130} However, the act has been amended to permit the SEC to exempt securities of an SBIC from registration if the SEC finds, after consideration of the purposes of the SBI Act, that the registration would not be necessary to protect the public interest or investors.\textsuperscript{131} In practice a copy of the proposal of the SBIC is sent to the

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\item \textsuperscript{117} 13 C.F.R. § 107.708(b) (1962), "... unless the total financing involved is $500,000 or less" then apparently any number over five may participate.
\item \textsuperscript{118} 13 C.F.R. § 107.710 (1963).
\item \textsuperscript{119} 13 C.F.R. § 107.710 (1962).
\item \textsuperscript{120} For a detailed consideration of this see Lese & Rotberg, \textit{Small Business Investment Companies and the Federal Securities Law}, 20 Fed. B.J. 343 (1960).
\item \textsuperscript{121} 48 Stat. 73 (1933), 15 U.S.C. §§ 77a-aa (1958).
\item \textsuperscript{123} 54 Stat. 848 (1940), 15 U.S.C. §§ 80a-1-52 (1958).
\item \textsuperscript{124} \textit{SENATE REPORT} 25.
\item \textsuperscript{125} The SBA is concerned primarily with the over-all regulation of the SBIC's operations; whereas, the SEC's main interest is in the protection of the investor's interests. \textit{Id.} at 27.
\item \textsuperscript{126} Issuer means every person who issues or proposes to issue any security. 48 Stat. 74 (1933), 15 U.S.C. § 77b(4) (1958).
\item \textsuperscript{127} Security includes stock, bond or other evidence of indebtedness. 48 Stat. 74 (1933), 15 U.S.C. § 77b(1) (1958).
\item \textsuperscript{128} 48 Stat. 906 (1933), 15 U.S.C. § 77c(b) (1958). The act authorizes the SEC to exempt issues under three hundred thousand dollars.
\item \textsuperscript{130} Lese & Rotberg, \textit{supra} note 120, at 349.
\end{itemize}
SEC and based upon the proposal, the SEC determines whether an exemption should be granted.132 The SEC rules provide that an SBIC is not engaged in a public offering when a small business exercises its option to purchase stock in the SBIC, and therefore no registration statement need be filed.133

The Trust Indenture Act of 1939 sets forth requirements for the public issuance of bonds, notes, and other evidences of indebtedness.134 The Act requires that an indenture cover any public issuance of debt securities135 and that a trustee be appointed thereunder.136 In the event of a default the trustee will exercise his powers to protect the rights and interests of the purchasers of the debt securities.137 In 1958, the Trust Indenture Act was amended to permit the SEC to exempt from the Act, any class of securities issued by an SBIC, if the SEC feels enforcement of the Act is "not necessary in the public interest and for the protection of investors."138

The Investment Company Act of 1940 is applicable to a firm which engages in investing in securities139 and has securities exceeding forty per cent of the value of its own total assets.140 The Act exempts from its provisions a company whose outstanding securities are beneficially owned by not more than one hundred persons and is not making and does not purport to make a public offering of its securities.141 If an SBIC has more than one hundred stockholders and is making a public offering it will be covered by the Act. The Act does not permit a company to issue debt securities unless it possesses assets to cover at least three hundred per cent of such securities, or to issue a common stock dividend unless there is at least three hundred per cent asset coverage or a preferred dividend unless there is at least two hundred per cent asset coverage.142 The Act exempts a covered SBIC from these limitations.143 A frequently contested restriction144 imposed by the Act, and one for which no exemption is granted to SBIC's, is that no company may issue stock for services or property other than for cash or securities.145 It is contended that this limitation prohibits management of SBIC's from enjoying stock options, a privilege that is available to executives in most other companies.146

133. 1 CCH Corp. Law Guide ¶ 3651 (1961).
144. Lese & Rotberg, supra note 120, at 359.
146. Lese & Rotberg, supra note 120, at 359.
D. Other Services Offered by an SBIC

The SBI Act directs that an SBIC should co-operate with banks and other investors whenever possible. The SBIC is permitted to charge a fee for servicing or initial investigation in connection with an acquisition of a security or a loan through banks or investors. The Act also encourages an SBIC to use the advisory services of the Federal Reserve System and the Department of Commerce and to provide advisory services on a fee basis to small businesses.

E. Legislation Affecting the Administration of the SBIC

It was hypothesized in 1960 that the lack of interest in forming SBIC’s was attributable to problems of administration. Consequently, in that year the following changes were effected: administration procedures were streamlined; SBA regulations were revised and published, and the SBA took a more aggressive approach to the administration of the program. An increase of interest up to the Spring of 1963, may be credited to the new program.

The SBA may make investigations, issue a cease and desist order, or suspend a license to assure SBIC compliance with the provisions and policy of the SBI Act. An SBIC is subject to examination by the SBA which is satisfied by an audit by a certified public accountant. If an examination discloses that the SBIC is operating contrary to the provisions and policy of the SBI Act, the SBA may issue a cease and desist order, but only after an order to show cause has been issued to the licensee and an administrative hearing on that order has been held.
The licensee has thirty days in which to contest the cease and desist order in the United States Court of Appeals.\textsuperscript{164} If the cease and desist order is upheld, the SBA may suspend the license of the SBIC until it complies with the order.\textsuperscript{165}

In addition to the foregoing administrative action, the SBI Act prescribes criminal penalties for bribery,\textsuperscript{166} extortion,\textsuperscript{167} embezzlement,\textsuperscript{168} filing fraudulent reports\textsuperscript{169} and fraud in applying for loans.\textsuperscript{170}

IV.

TAX BENEFITS OF FORMING AN SBIC

A. Present Tax Benefits

When the SBI Act was passed in 1958, Congress included in other legislation three special tax incentives to induce financiers to form an SBIC.\textsuperscript{171} In the next two years two other so-called incentives were added.\textsuperscript{172} These incentives cannot be fully appreciated unless one envisions what the tax status of an SBIC would be without the special privileges enjoyed by the company and its investors.\textsuperscript{173}

1. Advantages to the Investor in SBIC Stock

If the average investor buys stock in a company and sells it at a loss, it is considered a loss from the sale or exchange of a capital asset.\textsuperscript{174} The deduction of this loss in the case of a corporation is allowed only to the extent of gains from such sales or exchanges.\textsuperscript{175} For all other taxpayers the loss is allowed to the extent of gains from such sales or exchanges, plus the taxable income of the taxpayer or one thousand dollars, whichever is smaller.\textsuperscript{176} The investor in SBIC stock is permitted to deduct his losses

\textsuperscript{167}. SBI Act § 702(a), 72 Stat. 698 (1958), 18 U.S.C. § 216 (Supp. 1963) (receipt or charge of commissions or gifts by an officer, director, employee or attorney of an SBIC).
\textsuperscript{173}. A suspended SBIC and its stockholders lose all tax benefits they are normally entitled to because of SBIC status. 2 CCH Corp. Law Guide ¶ 11959 (1962).
\textsuperscript{175}. Int. Rev. Code of 1954, § 1211(a).
\textsuperscript{176}. Int. Rev. Code of 1954, § 1211(b).
on SBIC stock as if they were losses from the sale or exchange of property which is not a capital asset; the loss becomes an ordinary loss.\footnote{177. \textit{Int. Rev. Code of 1954, § 1242.} This privilege applies to any purchaser of SBIC stock, and is not restricted to the initial investor, but it has not applied to an investor who sold SBIC stock short. 2 \textit{CCH Corp. Law Guide} ¶ 11509 (1963).} For the individual taxpayer this is a saving\footnote{178. \textit{But only when the loss does not exceed the net long term gain from the sale of capital assets plus the greater of the individual's taxable income or one thousand dollars. \textit{Int. Rev. Code of 1954, § 1211(b).} Note there is no limit on individuals and partnerships as there is in "1244 Stock." \textit{Int. Rev. Code of 1954, § 1244.}} because he does not have to offset these losses against possible long-term capital gains.\footnote{179. \textit{He would thereby lose the benefit of a twenty-five per cent tax on such long term gains. \textit{Int. Rev. Code of 1954, § 1202.}}} The benefit to a corporate investor in SBIC stock is even more attractive. The corporation is not only permitted to offset such losses against ordinary income and preserve its long-term capital gains,\footnote{180. \textit{Int. Rev. Code of 1954, § 1242.}} but in the event of a net loss for the year, the corporation can use the SBIC loss as a part of its net operating loss deduction.\footnote{181.}

2. \textit{Advantages to the SBIC}

The SBIC is permitted to treat the losses on its convertible debentures, including stock received under the conversion privilege as an ordinary loss.\footnote{182. \textit{INT. REV. CODE OF 1954, § 1243.} There is no taxable gain realized on the exercise of such a conversion privilege. Silverstein, \textit{Tax Aspects of the 1958 Small Investment Act}, 39 \textit{Taxes} 7, 13 (1961). This article is recommended reading for anyone who desires a complete picture of the SBIC tax situation.} The tax advantages here are similar to those enjoyed by the corporate investor in an SBIC. The tax advantage of treating losses on the sale of stock as an ordinary loss applies only to stock acquired by conversion of debentures into stock.\footnote{183.}

All corporations are permitted under the Internal Revenue Code to exclude from taxation eighty-five per cent of the dividends received from domestic corporations, but the SBIC may exclude one hundred per cent of such dividends.\footnote{184. \textit{INT. REV. CODE OF 1954, § 243.}} This in itself can amount to a considerable tax saving, especially if the SBIC has substantial stock holdings or has transformed a substantial portion of its convertible debentures into stock.

These tax incentives, available to an SBIC when the SBI Act was passed, were increased in 1959. The new legislation, effective for the years ending December 31, 1958, relates to the status of an SBIC as a personal holding company.\footnote{185. \textit{INT. REV. CODE OF 1954, § 542(c) (11).}} A company is liable for an additional tax called a personal holding company tax\footnote{186. The tax varies between seventy-five per cent and eighty-five per cent of undistributed income.} if at any time during the last half of the taxable year more than fifty per cent in value of its outstanding shares are owned directly or indirectly by not more than five individuals,\footnote{187. \textit{INT. REV. CODE OF 1954, § 542(a) (2).}} and at
least eighty per cent\textsuperscript{188} of its income consists of dividends and profits from
stock and security transactions.\textsuperscript{189} It is readily seen that an SBIC is
subject to this tax, but the new legislation specifically excluded the SBIC
from the definition of a personal holding company.\textsuperscript{190} The exemption may
be lost if a stockholder of the SBIC owns five per cent of the stock of the
small business to which the SBIC makes a loan.\textsuperscript{191}

In addition to these legislative tax benefits, the Internal Revenue
Service in 1960 issued a new regulation which exempts an SBIC from the
penalty tax on unreasonable accumulations of earnings.\textsuperscript{192} The nature of
the SBIC's business makes favorable tax treatment in these two areas
necessary because most of the SBA's financing is a percentage of capital
and surplus.

B. Proposed Tax Benefits

In an attempt to increase interest in the SBIC program, and to confer
additional tax benefits to current SBIC's and its stockholders, Senate Bill
297 has been introduced by the Senate's Select Committee on Small
Business.\textsuperscript{193} One of the bill's provisions will permit SBIC's to set up
reserves for losses and bad debts and make reasonable additions thereto.\textsuperscript{194}
It is now possible under the Internal Revenue Code for a company to
receive a bad debt deduction provided the debt instrument involved is not
construed as a security.\textsuperscript{195} It is doubtful that an SBIC would qualify for
such a deduction under the present tax law, since approximately seventy
per cent of an SBIC's funds are extended to small businesses through
equity investments, and it is difficult to avoid construing a pure loan as a
security under the tax law.\textsuperscript{196} Proponents of such a deduction for SBIC's
contend that since savings and loan associations are permitted to maintain
an allowance for bad debts, the SBIC's should be likewise permitted.\textsuperscript{197}

As has been indicated, an SBIC is exempt from the accumulated
earnings tax by a regulation of the Internal Revenue Service.\textsuperscript{198} The
exemption will not apply if an SBIC ceases to engage actively in loaning
to small businesses. It is argued that this regulation is unreasonably
phrased and that the exemption should be made absolute because a company

\textsuperscript{188. INT. REV. CODE OF 1954, § 542(9) (I).}
\textsuperscript{189. INT. REV. CODE OF 1954, § 543.}
\textsuperscript{190. INT. REV. CODE OF 1954, § 542(c) (11).}
\textsuperscript{191. Ibid. Proposed legislation would, if enacted, increase this to ten per cent.
S. REP. NO. 297, 88TH CONG., 1ST SESS. (1963).}
\textsuperscript{192. Treas. Reg. § 1.533-1(d) (1960). Were it not for this exemption SBIC's
would pay a tax of between 27\%2 and 38\%2 per cent on earnings unreasonably
accumulated.}
\textsuperscript{193. For general terms of the bill see 2 CCH CORP. LAW GUIDE ¶ 11584 (1963).}
\textsuperscript{194. 2 CCH CORP. LAW GUIDE ¶ 11584 (1963).}
\textsuperscript{195. INT. REV. CODE OF 1954, § 166(c).}
\textsuperscript{196. SENATE REPORT 12.}
\textsuperscript{197. Ibid.}
\textsuperscript{198. See text accompanying note 192.}
may still be financing small business,\textsuperscript{199} and yet not actively engaged in such financing.\textsuperscript{200}

All SBIC's are currently exempt from the personal holding company tax provided an SBIC stockholder does not own five per cent or more of the stock of a company which the SBIC is financing.\textsuperscript{201} Under present legislation, it is possible for the Internal Revenue Service to contend that a stockholder of an SBIC constructively owns stock in the financed small business in a proportion equal to his interest in the SBIC. For example, if an individual owns fifty per cent of the stock of an SBIC and the SBIC owns fifty per cent of the stock of a small business the SBIC is financing (due to an outright purchase or exercise of conversion privileges) the SBIC stockholder would constructively own twenty-five per cent of the small business' stock. Proposed legislation would amend the exemption so that a stockholder of an SBIC would not be deemed a stockholder of a small firm solely by reason of his ownership of SBIC shares.\textsuperscript{202}

At present the Code permits certain regulated investment companies to pay income directly to their stockholders without any taxes being paid by the company, placing the entire tax burden on the stockholder.\textsuperscript{203} The Code requires that such companies, in order to qualify, must have at least ninety per cent of their gross income derived from dividends, interest, and gains from sales of securities, less than thirty per cent of its gross income derived from the sale of securities held less than three months, fifty per cent of its assets in cash and certain designated securities and not more than twenty-five per cent of its assets in securities of companies that it controls.\textsuperscript{204} It is possible that some SBIC's may qualify under these Code provisions, but an amendment is suggested which would permit all SBIC's to qualify as regulated investment companies and pass through income to their shareholders.\textsuperscript{205}

At the time the SBI Act was passed, SBIC's were not permitted to purchase directly the stock of a small business, but were limited to making loans and purchasing convertible debentures.\textsuperscript{206} The accompanying tax legislation permitted the SBIC to deduct as ordinary losses only losses on stock acquired by exercising the conversion privilege.\textsuperscript{207} The new legislation proposes that SBIC's be permitted to deduct losses on equity securities against ordinary income.\textsuperscript{208} Since SBIC's are now permitted to buy these

\textsuperscript{199} Treas. Reg. § 1.533-(d) (1960).
\textsuperscript{200} Silverstein, supra note 183, at 17.
\textsuperscript{201} INT. REV. CODE OF 1954, § 542(a) (2).
\textsuperscript{202} 2 CCH CORP. LAW GUIDE ¶ 11584 (1963).
\textsuperscript{203} INT. REV. CODE OF 1954, § 852.
\textsuperscript{204} INT. REV. CODE OF 1954, § 851.
\textsuperscript{205} 2 CCH CORP. LAW GUIDE ¶ 11584 (1963). The SBIC would be permitted a deduction for all dividends paid to stockholders, and could pass on capital gains to its stockholders, or keep them and pay the tax itself. INT. REV. CODE OF 1954, § 852.
\textsuperscript{206} SBI Act § 684(c), 72 Stat. 693 (1958).
\textsuperscript{207} INT. REV. CODE OF 1954, § 1243.
\textsuperscript{208} 2 CCH CORP. LAW GUIDE ¶ 11584 (1963).
securities directly, it appears the SBIC should be allowed ordinary loss treatment.

The remainder of the proposed tax legislation concerns what is commonly referred to as a tax option corporation or sub-chapter S corporation. Senate bill 297 would amend the Code to permit SBIC's to qualify as stockholders of a sub-chapter S corporation. Under the present statute it is impossible to elect to have the company's income taxed directly to the stockholder if the stockholder is a corporation. If the amendment is passed, it will be possible to have the income of a company in which the SBIC has substantial stock passed directly to the SBIC and not taxed to the earning company. These tax proposals are necessary changes which should be made to induce investors to own, buy stock in, and continue the existing operations of SBIC's.

V.

CRITICISM OF THE PROGRAM

The legislative changes of the SBI Act in 1960, brought about a substantial increase in the number of licensed SBIC's, but interest in the program is again beginning to wane. The cry for new legislative incentives has not as yet been heard by Congress. This, to be sure, is discouraging, but it is not the real problem. Something must be done to restore public confidence which has been lost because of marginal profits shown by current SBIC's, allegations of excessive interest rates, and charges that SBIC's demand too much of an equity interest in the small business they are financing. These three problems stem from two causes: small loans and small SBIC's.

The interest rate on a small loan is generally higher than on a larger one. The five hundred thousand dollar limitation precludes some SBIC's from making larger loans, and therefore smaller loans are made with accordingly greater interest charges. The shortage of income-producing funds in the small SBIC also helps to increase the interest rates. It has been shown that the operation of an SBIC is not a passive job, and that a larger amount of income-producing securities than was anticipated is necessary to assure financial stability of the SBIC. Proposed federal legislation, if adopted, will make more money available to SBIC's and therefore, give them more income-producing funds. This same legisla-
tion proposes to lift the five hundred thousand dollar limitation,\textsuperscript{220} thereby allowing the SBIC to make larger loans. The proposed legislation will apparently reduce the interest rates that are currently being charged by SBIC's.\textsuperscript{221} Certain proposed tax legislation will increase the SBIC's profit margin\textsuperscript{222} and will probably result in reduced interest rates. If the new legislation causes more SBIC's to be formed, competition among the SBIC's will increase, driving the interest rates lower.\textsuperscript{223}

The criticism that the demand of equity securities made by the financing SBIC is too large, can be traced to a misunderstanding of the purpose of the program.\textsuperscript{224} The SBI Act is designed to supply equity capital to small businesses, not simply to make long-term loans available.\textsuperscript{225}

Much of the criticism leveled at SBIC's can be disposed of without the aid of new legislation, if the SBA and the SBIC's explain the purposes of the program to the small businesses,\textsuperscript{226} however, the new legislation is necessary to enable the SBIC to continue to fill the equity gap.

VI.

CONCLUSION

Small businesses have been plagued by their inability to secure long-term loans and equity capital through normal financing channels resulting in what has been termed an equity gap. The most recent legislative answer to the problem of small business financing is the Small Business Investment Act of 1958 which authorizes the licensing of Small Business Investment Companies. The SBIC uses its operating capital, part of which may be secured from the Small Business Administration, to supply long-term loans and equity capital to small business. The operations of the SBIC are subject to regulation by the SBA and the Securities and Exchange Commission, but under certain conditions the SBIC may be granted immunity from SEC regulation.

There are at present significant tax benefits conferred by the Internal Revenue Code to the investor in SBIC stock and to the SBIC. The investors in SBIC stock are permitted to consider losses which result from the sale of SBIC stock as ordinary losses for income tax purposes. The SBIC is permitted to exclude from income one hundred per cent of the domestic corporations's dividends it received, and to take an ordinary loss deduction for losses incurred from the sale of convertible debentures. Proposed tax benefits to the SBIC would allow establishment of a bad debt

\textsuperscript{221} Senate Report 6, but SBIC's rates are usually lower than banks, investment companies, and factors.
\textsuperscript{223} Senate Report 12.
\textsuperscript{224} Id. at 6.
\textsuperscript{226} Senate Report 6.
reserve, passing through of income, ordinary loss deduction for a loss incurred from the sale of small business stock, and an election to become a tax option corporation.

The SBI Act reflects the efforts of the SBA to aid small business in obtaining financing.227 The Act, however, should not be expected to solve all the problems of small business.228 So far the legislation has been able to supply adequate financing to small business without the direct assistance of the federal government.229 The program also permits banks and other institutions to participate in more speculative investments and loans through an SBIC subsidiary than they would ordinarily be able to do.230 The future of the SBIC will depend on the response of the business community to the program, the passage of certain proposed legislative changes, the manner in which currently licensed SBIC's conduct themselves, and the attitude of the federal government.231

C. Dale McClain

227. See text accompanying note 16 supra.
231. Stewart, supra note 79, at 401.