The Small Business Investment Incentive Act of 1980 and Venture Capital Financing

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I. Introduction

The small business community is a diverse component of the national economy and is very often the leader in developing new technology, products and services. Traditionally, small businesses do not raise capital in the conventional public markets; rather, they generally receive their capital from that sector of the investment community referred to as the venture capital industry. The principal activities of a venture capital company consist of investing in, and providing managerial assistance to small growing busi-

1. Although there is no precise mathematical definition of what constitutes a small business, for purposes of this Comment the small business community includes new, small businesses, family and locally-owned and operated, and medium-sized, independent businesses. There are approximately twelve million such small businesses in the United States—more than 97% of all American companies. Report: “America’s Small Business Economy Agenda for Action”: Hearings Before the House Comm. on Small Business, 96th Cong., 2d Sess. 16 (1980) (estimates taken from Dun and Bradstreet) [hereinafter cited as 1980 White House Conference Report].

2. A study by the Office of Management and Budget shows that more than half of the major technological advances of the 20th century originated from small companies and individual investors. 1980 White House Conference Report, id. at 21. The majority of present-day venture capital has flowed to advanced technology companies, with a special emphasis on computer equipment, telecommunications, medical innovations and genetic engineering. N.Y. Times, Jan. 6, 1981, at D9, col. 2.

3. See notes 22-24 infra and accompanying text.

4. Financial experts invariably assert that new technology-based companies should be financed primarily with equity. See M. KIESCHNICK, VENTURE CAPITAL AND URBAN DEVELOPMENT 49 (1979) [hereinafter cited as VENTURE CAPITAL]. Simply stated, equity is the right of the investor to a share of income after all costs have been paid. Id. See also note 19 infra.

5. See note 23 infra and accompanying text. Investors in venture capital companies expect that their investments must be held for a period of years before significant capital appreciation is likely to occur. Since the enterprises in which venture capital companies invest are in the embryonic stages of development, any initial earnings made by these enterprises are put back into the enterprise for future growth rather than disbursed in the form of dividends. Hence, investors are not looking for current yields but the eventual realization of long-term capital gains. In the late 1960’s, venture capitalists made substantial profits by being able to sell their shares in young, developing companies at high multiples of their
nesses. In return, the venture capital company expects long-term appreciation of the securities in which it invests. Once a venture capital company becomes publicly held or reaches a certain size, however, it becomes subject to detailed regulation under the Investment Company Act of 1940. The venture capital industry has consistently maintained that it cannot operate and function efficiently under the strictures imposed by the 1940 Act and the result has been the creation of few new publicly owned venture capital firms and the lack of growth of those venture capital firms already in existence. The ability of small, expanding firms to raise investment capital has been steadily decreasing during the 1970’s.

initial investment through the public capital markets. Venture Capital, supra note 4, at 49. Substantial profits have also been made recently as well. One venture capitalist has stated that an initial investment of $178,000 in December 1977 resulted in a sale in February 1980 for $60 million. N.Y. Times, Jan. 6, 1981, at D9, col. 2.


8. Between 1969 and 1979, no new publicly owned venture capital companies came into existence and the number of publicly owned venture capital companies that were created in prior years diminished due to liquidation or acquisition. Small Business Investment Incentive Act: Hearings Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 96th Cong., 1st Sess. 182 (1979) (statement of Russel Carson). A particular form of venture capital company is a small business investment company—a privately owned, privately operated investment company licensed by the Small Business Administration, which seeks to provide capital, long-term loans, and managerial assistance to eligible small businesses. In 1963, there were 30 publicly owned small business investment companies with total private capital of $350 million. As of June 1980, there were 14 publicly traded small business investment companies with only $90 million of total private capital. 1980 Venture Capital Hearings, supra note 7, at 182. See also Turner, SBICS, MESBICS and Conflicts of Interest, 36 Fed. Bar. J. 185 (1977); Mendelsohn & Cerino, Application of the Federal Securities Laws to Minority Enterprise Small Business Investment Companies “Mesbics”, 16 How. L. J. 744 (1971).

9. Several executive agencies and private organizations have performed studies directed to the capital formation problems of small enterprises, and have concluded that risk capital
This trend has impeded innovation and has gradually weakened the economy. In order to help stimulate the growth and creation of the venture capital industry and thus increase the flow of capital to small businesses, Congress has enacted the Small Business Investment Incentive Act of 1980 ("1980 Act"). Part II of this Comment will discuss the impact of the small business community upon the national economy and the method by which such small companies are usually financed. Part III will examine the negative effects which the Investment Company Act of 1940 ("1940 Act") has had upon venture capital companies in the form of a decrease in the flow of capital to the small business community. The focal point of Part III will be upon the application of section 17 to venture capital companies. Finally, Part IV will explore the basic framework underlying the 1980 Act and how it attempts to alleviate the regulatory burdens under section 17 of the 1940 Act.

II. The Small Business Community

The importance of the small business community in the areas of innovation, productivity, increased competition, and the jobs they create cannot be overstated. Extensive research by the Senate in recent years has become extremely difficult to raise. See 126 Cong. Rec. S13469 (daily ed. Sept. 25, 1980). The most widely recognized of these studies is the one undertaken by the Small Business Administration. U.S. SMALL BUSINESS ADMINISTRATION, SBA Task Force on Venture Capital for Small Business (Jan. 1977) (commonly referred to as the Casey Report, after former SEC chairman William J. Casey). The report concluded that venture capitalists have been avoiding young businesses, using their funds instead to take positions in established companies. See also Small Business Access to Equity and Venture Capital: Hearings Before the Subcomm. on Capital, Investment and Business Opportunities of the House Comm. on Small Business, 95th Cong., 1st Sess. 17 (1977) (statement of William J. Casey). 126 Cong. Rec., supra note 9, at S13469.

10. See note 11 infra.


13. The National Science Foundation reported that small firms (1000 employees or fewer) incur one-fourth the cost per innovation of medium-sized firms (1000 to 10,000 employees) and one-twenty-fourth the cost of large firms (over 10,000 employees). 126 Cong. Rec., supra note 9, at S13469-70.

14. See note 17 infra.
Small Business Committee has established that new, small and independent firms have a pervasive, positive effect in their contribution to the economy.\textsuperscript{15} The Committee estimates that new and small firms may account for as much as twenty to twenty-five percent of actual economic growth.\textsuperscript{16} Other studies reveal that small business is a significant factor in the maintenance and growth of private sector employment.\textsuperscript{17} The size of the enterprise gives rise to advantages and disadvantages on either side of the spectrum.

One of the primary distinctions between large and small enterprises is the method by which each engages in capital formation.\textsuperscript{18} For established businesses, raising capital is accomplished by either securing adequate bank financing or the issuance of stocks and bonds to the public.\textsuperscript{19} For small, developing companies, especially those engaged in the discovery of new technology and ser-

\textsuperscript{15} "Numerous studies establish that local businesses are a prime source of strength for their neighborhoods and communities and are the repository of many of the most deeply held American values, such as self-reliance, individuality, economic opportunity, hard work, craftsmanship, and human scale." 126 Cong. Rec., supra note 9, at S13470 (quoting from Senate Small Business Comm. Print, Nov. 7, 1977).

\textsuperscript{16} Id. at S13469.

\textsuperscript{17} Fifty-two percent of new jobs generated between 1960 and 1976 were by independent businesses with less than 20 employees. Id. at S13470. The Small Business Administration reports that 55\% of all existing jobs in the private sector are in small business. Id. The first White House Conference on Small Business stated that new and existing small businesses in recent years have provided 86.7\% of new jobs in the private sector. 1980 White House Conference Report, supra note 1, at 20. But see VENTURE CAPITAL, supra note 4, at 29, wherein it is felt that empirical knowledge of the small business sector of the economy is seriously incomplete.

\textsuperscript{18} Capital from outside sources is generally more difficult to obtain for small businesses than for larger ones, yet small companies, particularly young and expanding ones, rarely have sufficient earnings to support their growth. 1980 White House Conference Report, supra note 1, at 61.

\textsuperscript{19} I.R.C. § 385 authorizes the Department of the Treasury to define corporate stock and debt by regulations for all purposes of the Internal Revenue Code. Section 385 lists certain characteristics which may be taken into account in the regulations in determining whether an instrument should be classified as debt or equity: (a) whether there is a written unconditional promise to pay on demand or on a specified maturity date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (b) whether there is subordination to or a preference over other debt, (c) the ratio of debt to equity, (d) convertibility and (e) the relationship between stock and debt holdings of the investor. See Thrower, Conglomerates—Some Tax Problems, 25 Bus. Law. 641 (1970); N.Y. State Bar Association Tax Section Committee on Reorganization Problems, Recommendations as to Federal Tax Distinction Between Corporate Stock and Indebtedness, 25 Tax Law. 57 (1971). See also Jacobs, Small Business, Wall St. J., Jan. 26, 1981, at 23, col. 1 (final tax rules on debt and equity).
vices, access to such traditional capital markets is effectively barred because the risks associated with these companies may be quite substantial. In response to this void in traditional capital sources necessary to finance new enterprises, there has emerged a new source of financing commonly referred to as venture capital, which is the provision of equity and debt capital to young, small firms by a class of entrepreneurs known as venture capital companies.

Although the term "venture capital company" has never been universally defined, certain characteristics distinguish a venture capital company from a traditional investment company. A venture capital company furnishes capital directly to enterprises which cannot obtain capital in public markets. The paucity of a public market for the securities held by the venture capital company makes venture capital company investments illiquid and the rate of portfolio turnover quite low. Furthermore, a venture capital company frequently enters into transactions with the investee company and actively participates in the operations of the investee company. Officers of the venture capital company often sit on the

20. Start-up capital for small entrepreneurs usually comes from the entrepreneur's savings and "sweat equity" or from friends and relatives. It is not until the company becomes established before it may raise equity capital by selling shares through a public offering. 1980 White House Conference Report, supra note 1, at 62.

21. See notes 75-77 infra and accompanying text.


23. Basically, there are two reasons why venture capital companies must forego current appreciation and instead seek long-term capital gains. First, new companies cannot generate enough retained earnings to finance their growth but instead constantly require new injections of equity; therefore, such new companies cannot afford to pay out scarce equity in the form of dividends. Second, the risks of investing in new companies are extremely high, and consequently, investors demand a higher return on their investment. Such returns do not come from dividends but from capital gains. 1978 Small Business Hearings, supra note 7, at 257. The amount of long-term appreciation, however, can be quite formidable. According to one of the most successful individual venture capitalists in the country, Frederick Adler, his initial net worth of $50,000 in 1967 has now grown to over $100 million. N.Y. Times, Jan. 6, 1981, at D1, col. 4. The Narragansett Capital Corporation, note 7 supra, had over $9 million of net income for the year ended Dec. 31, 1980. N.Y. Times, Feb. 12, 1981, at D8, col. 8.

24. As important as capital is to developing companies, they often need assistance in planning, financial analysis, and other aspects of business. The venture capital company, unlike the passive institutional investor, is often the best source of guidance to a new firm. 126 Cong. Rec., supra note 9, at S13459. In fact, the 1980 Act does provide that a business development company must make available "significant managerial assistance" to companies which are treated by the business development company as satisfying the 70% of the value of its total assets condition of new § 55. For a detailed discussion of exactly what
While venture capital companies are the primary source of capital for developing companies, the flow of capital funds has ebbed in recent years. The statistics of the past several years establish that small enterprises have encountered great difficulties in raising venture and equity capital and at times virtually have been excluded from United States capital markets.

The venture capital industry has stated that the reasons for the shortage of capital are the inability of venture capital companies to have public markets for their own equity securities without being subject to detailed regulations under the 1940 Act and the unwillingness of venture capital businessmen to try and operate under the 1940 Act as it existed. Several hearings were held concerning "significant managerial assistance," see notes 96-104 infra and accompanying text.

25. See note 9 supra. A study conducted by the American Electronics Association revealed that new and small firms founded between 1971 and 1975 were able to raise on the average less than 30% as much capital as firms founded during 1966 and 1970 raised between 1966 and 1970. 1978 Small Business Hearings, supra note 7, at 255. Another item demonstrating the general lack of capital availability is the dramatic decrease of capital raised pursuant to registered stock issues over the past decade. In 1968 and 1969, 1,056 small companies were able to raise over $2 billion in equity capital from the public. In 1978 and 1979, only 79 small companies were able to go public for an amount totalling $400 million. 126 Cong. Rec., supra note 9, at S13470.

26. BUSINESS WEEK, Oct. 17, 1977, at 63, col. 1. Given the impact that small businesses have on the economy, such a dearth of capital could eventually cause substantial damage to economic growth. The Senate Small Business Committee did in fact conclude that the problems of capital formation faced by new and small businesses during the 1970's are causing damage to the national economy. 126 Cong. Rec., supra note 9, at S13469.

27. A thorough and complete description of the application of the 1940 Act to venture capital companies and the general problems which venture capital companies felt existed under the 1940 Act can be found in the statement of E.F. Heizer, Jr. (chairman and founder of the Heizer Corp). See 1978 Small Business Hearings, supra note 7, at 49.

28. Id.

ing the relationship between venture capital financing and the 1940 Act, but there was no resulting legislation.\textsuperscript{30} It was not until the passage of the Small Business Investment Incentive Act of 1980 that representatives of the venture capital industry and the Securities and Exchange Commission (“Commission”) finally were able to agree upon legislation which incorporates appropriate relief with the investor safeguards of the 1940 Act.\textsuperscript{31}

### III. The Investment Company Act of 1940

The Investment Company Act of 1940 is a comprehensive federal regulatory scheme designed to protect shareholders of investment companies from a variety of improper practices that had become widespread during the 1930’s.\textsuperscript{32} The main abuses which

\textsuperscript{30} H.R. 3991, as reported in the Small Business Investment Incentive Act: Hearings Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 96th Cong., 1st Sess. (1979), was designed to amend § 3(c) of the 1940 Act to totally exclude venture capital companies from the definition of an investment company. The Securities and Exchange Commission (“Commission”) strongly opposed this bill on the grounds that it would substantially reduce the protection afforded to both unsophisticated and sophisticated investors. The Commission did concede that there did exist a need to aid small businesses in raising capital, but felt that such a need should not be accomplished by a dilution of investor protection. This view was reaffirmed by the Commission in the 1980 Venture Capital Hearings, supra note 7, at 56.

The abuses which the Commission felt would arise if venture capital companies were excluded from the 1940 Act can be found in certain civil proceedings, all dealing with violations of section 17. Securities and Exchange Comm’n v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); Creative Capital Corp., (Investment Company Act Release No. 7791, April 26, 1973); Illinois Capital Investment Corp., (SEC Litigation Releases Nos. 4699, 4777, Oct. 9, 1970); Puerto Rico Capital Corp., (SEC Litigation Release No. 3308, Aug. 13, 1969). But see 1980 Venture Capital Hearings, supra note 7, at 210, where, after an analysis of these four civil proceedings, it was concluded that the Commission could instead protect shareholders against overreaching and fraud under the Securities Exchange Act of 1934, irrespective of the 1940 Act.

This does not seem to represent such a great loss of shareholder protections, particularly when weighed against the cost of compliance with the Investment Company Act and its chilling effect on the development of new venture capital.

\textsuperscript{31} See Huffman, SEC Polishes Hill Image with Venture Capital Bills, Legal Times of Wash., Aug. 18, 1980, at 4, col. 1 (political pressure played a role in finally forcing the Commission to reach a compromise).

developed in the investment company industry were abuses related to the very nature of investment companies and their affiliations. 33

One of the more egregious problems specifically identified was the advantage the affiliated ‘‘insiders’’ had over the public investors. 34

In order to remedy this practice, section 17 of the 1940 Act was drafted to prohibit securities transactions between investment companies and affiliated persons, 35 except upon the granting of a


33. Since the assets of such companies are highly liquid and consist primarily of cash and securities, there exist easy opportunities for embezzlement or theft.

Basically, the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies.


35. ‘Affiliated person’ of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. § 80a-2(a)(3) (1976). Section 17 has been construed to afford protection to the stockholders of the affiliated persons as well. See Fifth Avenue Coach Lines Inc., 43 S.E.C.
Commission exemption. While section 17 has been described by the Commission as the "keystone" of the 1940 Act, it is also that section which has worked a particular hardship on the operations of venture capital companies.

A. Section 17—Transactions of Certain Affiliated Persons and Underwriters

Section 17 is intended to prevent abuses and unfair transactions by insiders of investment companies by requiring prior indepen-

635, 639 (1967).

36. The histories of the securities acts indicates that Congress intended to eliminate the abuses which contributed to the stock market crash of 1929. Securities and Exchange Comm’n v. Capital Gains Bureau, 375 U.S. 180, 186 (1963). The 1933 and 1934 Acts were designed to assure that full disclosure would be made to prospective investors and purchasers in order to provide for investor protection and thereby restore public confidence in the securities industry. Comment, Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion, 10 COLUM. J. L. & Soc. PROB. 328, 332-34 (1974). More specifically, the 1933 Act seeks to provide investors, through a registration process, with the information necessary to make informed judgments as to new securities publicly offered and to prohibit fraudulent and deceptive practices in the sale of securities. Id. at 329. The 1934 Act establishes the Commission to oversee the enforcement of the securities laws with broad, though not unlimited, administrative powers to help extend maximum protection to the investing public. Id. For a discussion of the remedial purposes of the securities acts, see generally 1 L. Loss, SECURITIES REGULATIONS 1-158 (2d ed. 1961); 4 L. Loss, SECURITIES REGULATIONS 2201-94 (2d ed. Supp. 1969).


38. The term "investment company," as defined in 15 U.S.C. § 80a-3(a) (1976 & Supp. II 1978), means any issuer of securities which either engages primarily or proposes to engage primarily in the business of investing, reinvesting, or trading in securities, or which owns or proposes to acquire investment securities, or which owns or proposes to acquire investment securities whose value exceeds 40% of the value of the issuer’s total assets. Section 3(a) has been criticized for being too broad, and thus including within its scope companies for which the 1940 Act was not designed to regulate. For example, an industrial corporation that finds itself with 40% or more of investment securities comes within the definition. See, e.g., Atlantic Coast Line Co., 11 S.E.C. 661 (1942). See also Kerr & Appelbaum, Inadvertent Investment Companies—Ten Years After, 25 BUS. LAW. 887, 905 (1970); Rosenblat & Lybecke, Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project, 124 U. PA. L. REV. 587, 600-10 (1976) [hereinafter cited as External Investment Management]. Arguments have been made by the National Association of Small Business Investment Companies that the 1940 Act was not intended to regulate small business investment companies, however, such arguments have not been met with favor by the Commission. 1978 Small Business Hearings, supra note 7, at 141, 187.

A "company" is defined in 15 U.S.C. § 80a-2(a)(8) (1976 & Supp. II 1978) to mean a "corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not. . . ." A company need not be a
dent scrutiny by the Commission of transactions between an investment company, its investment advisor, or other "affiliated persons." Such transactions, which do involve possible conflicts of interest, are governed by subsections (a) and (d). In brief, section 17 (a) generally prohibits any affiliated person (or any affiliated person of such an affiliated person)


41. It shall be unlawful for any affiliated person . . . of a registered investment company . . . or any affiliated person of such a person . . . acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company . . . .

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 80a-21(b) of this title.


42. It shall be unlawful for any affiliated person of . . . a registered investment company . . . or any affiliated person of such a person . . . acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person . . . in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant . . . .


43. An affiliated person of an affiliated person is commonly referred to as a "second-tier" affiliate. See note 51 infra and accompanying text. The "second-tier" affiliate problem is regarded as one of the more complex and troublesome areas of the 1940 Act. It has been stated that

The problems that can arise under the [Investment Company] Act for such portfolio affiliates or companies, which, in turn, are affiliated with them should be of interest not only to 1940 Act buffs, but to any lawyer for an operating company the shares of which are the object of the affections of any mutual fund. The topic also should appeal to double-crostic fans.
of a registered investment company knowingly from selling, purchasing, or borrowing securities\textsuperscript{44} or other property from the investment company; section 17(d) generally empowers the Commission to establish rules and procedures restricting any affiliated person (or any affiliated person of such affiliated person) of a registered investment company acting as principal from effecting any transaction in which the investment company (or a company controlled by the registered investment company) is a “joint or joint and several”\textsuperscript{45} participant with the affiliated person.

1. Application of Section 17(a) to Venture Capital Companies

The affiliated persons of a venture capital company, as the term is used in section 17(a), can be divided into two major groups: 1) “upstream” affiliates, who can control or can influence a venture capital company, and 2) “downstream” affiliates, whom the venture capital company controls or can influence. The upstream affiliates of a venture capital company normally consist of its directors,\textsuperscript{46} officers and employees, and each stockholder of a venture capital company owning five percent or more of its common stock.\textsuperscript{47} The downstream affiliates\textsuperscript{48} consist of all the companies of

\textit{External Investment Management, supra} note 38, at 652 (quoting Kroll, \textit{The “Portfolio Affiliate” Problem}, \textit{Third Annual Institute on Securities Regulations} 261 (R. Mundheim & A. Fleischer, Jr. eds. 1972)).


45. There is little authority construing the terms “joint or joint and several,” see, e.g., Securities and Exchange Comm’n v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); Securities and Exchange Comm’n v. Talley Indus., Inc., 399 F.2d 396 (2d Cir. 1968), \textit{cert. denied sub nom.} General Tire Corp. v. Securities and Exchange Comm’n, 393 U.S. 1015 (1969); Securities and Exchange Comm’n v. Midwest Technical Dev. Corp., [1961-1964 Transfer Binder] \textit{Fed. Sec. L. Rep.} (CCH) ¶ 91,252 (1963). Given the purpose of § 17, however, it is reasonable to conclude that § 17(d) not only encompasses the situation of a direct transaction between the investment company and an affiliate, but also situations in which the investment company and its affiliate agree to purchase or sell shares in another company. \textit{See} Martin, \textit{Federal Regulation of Real Estate Investment Trusts: A Legislative Proposal}, 127 U. Pa. L. Rev. 316, 337 (1978).

48. The problem of self-dealing by “downstream affiliates” was not addressed by either the Commission or Congress during the 1940 hearings. \textit{External Investment Management, supra} note 38, at 653.
which the venture capital company owns five percent or more of the voting securities.\(^49\)

In addition to upstream and downstream affiliates, section 17(a) also prohibits transactions between a venture capital company (or the companies it controls) and affiliated persons of its affiliated persons.\(^50\) This group, referred to as “second-tier” affiliated persons,\(^51\) consists mainly of persons who are related to each corporate affiliated person of the venture capital company.\(^52\) The very nature of a venture capital company, unlike that of a traditional investment company, requires it to deal with its affiliated persons\(^53\) on a regular basis in the ordinary course of business. Consequently, virtually every transaction\(^54\) of a venture capital company runs the

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51. For a good description of the “second-tier” affiliate problem, see External Investment Management, supra note 38, at 651-54.
52. Included in the second-tier are: 1) each director of each corporate affiliated person of the venture capital company, 15 U.S.C. § 80a-2(a)(3)(D) (1976), 2) each officer or employee of each corporate affiliated person of the venture capital company, id., 3) each person owning five percent or more of the voting securities of each corporate affiliated person of the venture capital company, 15 U.S.C. § 80a-2(a)(3)(A) (1976), and 4) each company, five percent or more of whose securities are owned by such corporate affiliated persons of the venture capital company, 15 U.S.C. § 80a-2(a)(3)(B) (1976). Also within the second-tier is each partner or employee of each natural affiliated person of the venture capital company, 15 U.S.C. § 80a-2(a)(3)(D) (1976) and each company five percent or more of whose voting securities are owned by each natural affiliated person of the venture capital company, 15 U.S.C. § 80a-2(a)(3)(B) (1976) (“person” means a natural person, or a company, 15 U.S.C. § 80a-2(a)(28) (1976)).
53. 1978 Small Business Hearings, supra note 7, at 81.
54. The following representative examples demonstrate the restraints placed upon venture capital companies by § 17(a):

(1) Assume a bank owns five percent or more of the voting securities of a venture capital company, thereby qualifying as an upstream affiliate of the venture capital company. Section 17(a) not only bars the bank from dealing with the venture capital company, but also bars the affiliated persons of the bank (the second-tier affiliates) from dealing with the venture capital company. This group includes all of the directors, officers and employees of the bank, and all the companies of which the bank owns five percent or more of the outstanding voting securities. It is likely that a bank, through trust accounts and other methods, holds the power to vote five percent or more of the outstanding voting securities of numerous, small developing companies. If, in an independent business judgment, the venture capital company decides to invest capital in one of these small companies whose stock is held by the bank, then § 17(a) is violated and the transaction can be held void in accordance with 15 U.S.C. § 80a-46(b) (1976). 1978 Small Business Hearings, supra note 7, at 82.

(2) Assume that a venture capital company owns a controlling interest of a small, developing company and that one of the venture capital companies’ investors is an insurance company that owns five percent or more of the venture capital companies’ securities. If an em-
risk of being in violation of section 17(a),\textsuperscript{55} thereby causing hesitation on the part of venture capital companies prior to entering into those transactions which may be necessary for the continued existence of the investee company.

2. The Application of Section 17(d) to Venture Capital Companies

Section 17(d)\textsuperscript{56} makes it unlawful for any affiliated person of an investment company or any affiliated person of such person, to effect any transaction in which the investment company is a "joint or joint and several" participant\textsuperscript{57} with such affiliated person without first obtaining the approval of the Commission. Just as in section 17(a), section 17(d) seeks to protect investment companies and their shareholders from overreaching and self-dealing by affiliated persons.\textsuperscript{58} The basic difference is that while section 17(a) is concerned with unfairness and overreaching in transactions in

\footnotesize{ployee of the insurance company buys a used desk from the developing company, then this purchase can be void under § 17(a). It is worth recognizing that there is virtually no reasonable way for the employee, the insurance company, or the venture capital company to recognize the illegality of the transaction. (A presumption of control arises where one, whether directly or indirectly, owns 25\% or more of another's outstanding voting securities. 15 U.S.C. § 80a-2(a)(9) (1976)). 1978 Small Business Hearings, supra note 7, at 83.

55. The Commission has attempted to extend relief to venture capital companies and small investment companies through Rule 17a-6. 17 C.F.R. § 270.17a-6 (1980). Venture capital firms, however, have stated that the Rule is so vague and complex that such relief is meaningless. 1980 Venture Capital Hearings, supra note 7, at 165; 1978 Small Business Hearings, supra note 7, at 79. For example, a vital element for an exemption under Rule 17a-6 is the term "direct or indirect financial interest." 17 C.F.R. § 270.17a-6(a)(5)(ii) (1980). Yet this term is not defined in the rule or the 1940 Act; rather, the Rule only lists a few situations which the Commission deems to be excluded from the meaning of the term "financial interest." There is no "de minimis" standard or any other type of practical limitation to help venture capital companies determine what is meant by "financial interest." It is not unusual, therefore, for venture capital companies to hesitate entering into transactions which may be violative of § 17, because under 15 U.S.C. § 80a-46(b) (1976), every contract made in violation of the 1940 Act would be void. The 1980 Act now would save such a contract if a court finds that enforcement 1) would produce a more equitable result than nonenforcement and 2) would not be inconsistent with the purposes of the Act. 1980 Act, Pub. L. No. 96-477, 94 Stat. 2277 (1980) (to be codified at 15 U.S.C. § 80a-46(b)).

56. 15 U.S.C. § 80a-17(d) (1976) (for the precise language of § 17(d) see note 42 supra). Draftsmen for the proposed Federal Securities Code have stated that § 17(d) is perhaps the most troublesome provision in the entire Act. 1978 Small Business Hearings, supra note 7, at 86 n.46.

57. See note 45 supra.

58. For the legislative history and purpose of § 17(d), see External Investment Management, supra note 38, at 643-44 n.178.
which the investment company and its affiliates are on opposite sides of the bargaining table, section 17(d) is intended to regulate the situation where the investment company and its affiliates are united in interest. One of the more important features of this subsection is that for conduct to be unlawful under section 17(d), it must be in contravention of some rule or regulation of the Commission issued under the authority of section 17(d). The Commission has responded by promulgating Rule 17d-1.69 Just as under section 17(a), section 17(d) and Rule 17d-1 also create potential difficulties for venture capital companies.60

59. 17 C.F.R. § 270.17d-1 (1980). Rule 17d-1(a) prohibits, without prior Commission approval, joint enterprises between a venture capital company (or one of its controlled companies) and any affiliated person, any underwriter and any affiliated person of such an affiliated person or underwriter. (17 C.F.R. § 270.17d-1(c) (1980), defines joint enterprises as "any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking.").

17 C.F.R. § 270.17d-1(b) (1980) provides that in passing judgment upon an application for an application for an exemption the Commission is to consider whether the investment companies' participation in the transaction is consistent with the purpose of the 1940 Act, and the extent to which such participation is on a basis different from or less advantageous than that of other participants. For examples of the types of transactions held to be within § 17(d) and Rule 17d-1, see 4 Fed. Sec. L. Rep. (CCH) ¶ 48,399.

An exemption to the prohibitions in Rule 17d-1 has been established in Rule 17d-1(d)(5). This rule permits joint transactions, without Commission approval, between an investment company and an affiliate of the investment company where certain key persons of the investment company do not have a "financial interest" in the joint transaction, and neither the investment company nor a controlled company commits greater than five percent of its assets to the joint transaction. Because the substance of this rule is very similar to that of Rule 17a-6, 17 C.F.R. § 270.17a-6 (1980), any difficulties which arise are also very similar. For the problems encountered in Rule 17a-6, see note 55 supra. Hence, Rule 17d-1(d)(5) does not present substantial relief to venture capital companies.

60. The following examples are illustrative of some typical venture capital company problems that may arise pursuant to § 17(d) and Rule 17d-1:

(1) If a venture capital company decides to implement a pension plan in order to attract qualified personnel, such a pension plan is a joint enterprise under Rule 17d-1(d)(5), 17 C.F.R. 270.17d-1(d)(5) (1980), and is not allowed because the employees have an obvious "financial interest" in the transaction. Thus, unlike most other businesses, a venture capital company needs Commission approval before it may establish a pension plan. 1978 Small Business Hearings, supra note 7, at 89.

(2) Assume that a venture capital company owns five percent of the voting securities of a new, developing company (company X) and that such company is seeking to make a public offering of its securities. At the time the venture capital company acquired the stock of company X, it contracted with the company to allow the venture capital company to sell its company X shares as part of the same registration statement that company X may eventually use for a public offering. Now suppose that the venture capital company is also offering its own shares to the public and that an investment banking firm is a member of the under-
B. Exemption Procedures From the 1940 Act

1. Section 17(b)—Transaction Exemptions

Notwithstanding the barring of a transaction by sections 17(a) and (d), it is possible to obtain an order from the Commission exempting the transaction from the applicable prohibitions. Section 17(b) provides the mechanism by which, upon application, the Commission may exempt any proposed transaction if: 1) the evidence establishes that the terms of the proposed transaction are reasonable and fair and do not involve overreaching, 2) the proposed transaction is consistent with the policy of each investment company involved; and, 3) the proposed transaction is consistent with the general purpose of the 1940 Act. While section 17(b) may be efficient for investment companies such as mutual funds, it is too restrictive, too time-consuming and too costly to be of writing syndicate for both the venture capital company and for company X. Under these circumstances, the venture capital company cannot exercise its contract to sell its company X shares without first obtaining prior Commission approval. This is necessary because the investment banker is deemed to have a financial interest in the company X offering and such an interest violates Rule 17d-1(d)(5). Waiting for such Commission approval may very well jeopardize the company X offering and thereby create a disadvantage to the venture capital companies’ shareholders in that they are forced to keep the shares of company X beyond that which they desire. Id. at 88.

62. For a representative sampling of those transactions granted a section 17(b) exemption, see 4 Fed. Sec. L. Rep. (CCH) ¶ 48,374.
63. 15 U.S.C. § 80a-37 (1976) grants the Commission authority to issue rules and regulations necessary or appropriate for the Commission to exercise its power under the 1940 Act. Consequently, the Commission has promulgated rules concerning the procedures to be followed in requesting a hearing or review. 17 C.F.R. §§ 201.1-201.28 (1980). As a practical matter, exemption proceedings under section 17(b) require a minimum of sixty days. See 1978 Small Business Hearings, supra note 7, at 92. See also External Investment Management, supra note 38, at 639 (Section 17(b) is a cumbersome application procedure and often prevents timely execution of the proposed transaction).
64. The inordinate amount of time necessary to obtain a § 17(b) exemption is best illustrated in Grace v. Ludwig, 484 F.2d 1262 (2d Cir. 1973). In Grace, an exemption order was initially filed on July 31, 1967. On Oct. 25, 1967 the Commission directed hearings to take place and such hearings were conducted from Jan. 4, 1968 to June 7, 1968. Seventeen witnesses testified, resulting in a 7500 page transcript. The parties then waived an initial decision by the hearing examiner and opted for a full hearing before the Commission, which was held on Nov. 12, 1968. See also Saylor v. Lindsley, 456 F.2d 896 (2d Cir. 1972) (an application for a § 17(b) exemption was filed in Jan. 1953 and the exemption was not granted until Nov. 1953); cf. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977) (a delay caused while waiting for Commission approval of a merger resulted in further stock speculation which was damaging to the parties).
any practical value to a venture capital company.

2. Section 3(c)(1)—Exemption from the 1940 Act

It is possible for a venture capital company to exist without having to comply with the 1940 Act so long as it initially and continually complies with the following conditions for exemption as found in section 3(c)(1):\(^6\) 1) the funds necessary to finance the venture capital business must be obtained from 100 or fewer investors; 2) an investment company owning more than ten percent of a venture capital companies' voting securities\(^7\) may not devote more than ten percent of its assets to investment in the venture capital company without having its own shareholders or partners treated as owners of the venture capital companies' securities for purposes of the 100 or fewer beneficial investors limitation; and 3) the venture capital companies' stock offering must qualify as private under the Securities Act of 1933.\(^8\)

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The Commission's determination under § 17(b) does not preclude a court from examining the fairness of such a decision. Harriman v. E. I. du Pont de Nemours & Co., 411 F. Supp. 133 (D. Del. 1975). In reviewing a decision of the Commission, a court must consider both the facts and the application of the relevant statute by the agency. Congress has mandated that in review of § 17 proceedings, "[t]he findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." 15 U.S.C. § 80a-42(a) (1976). A reviewing court is also to be guided by the "venerable principle that the construction of the statute by those charged with its execution should be followed unless there are compelling indications that it is wrong. . . ." Red Lion Broadcasting Co. v. Federal Communications Comm'n, 395 U.S. 367, 381 (1969). See, e.g., E. I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46 (1977), in which the Court held that the lower court erred in rejecting the Commission's conclusion and substituting its own judgment. Res judicata and collateral estoppel do not ordinarily apply to decisions of administrative tribunals. Niagara Mohawk Power Corp. v. Federal Power Comm'n, 202 F.2d 190, 198 (D.C. Cir. 1952), aff'd, 347 U.S. 239 (1954). As applied to the Commission, see Entel v. Allen, 270 F. Supp. 60, 66 (S.D.N.Y. 1967).

65. 1978 Small Business Hearings, supra note 7, at 93. An official of the National Association of Small Business Investment Companies has stated that due to the length of time required to obtain a § 17(b) exemption, many transactions have been avoided to the economic detriment of the companies involved and their shareholders. Id. at 234 (statement of Peter van Oosterhout). See also 1980 Venture Capital Hearings, supra note 7, at 173-74. (the legal costs alone of obtaining two transaction exemptions were $20,000 and $29,000, respectively) (statement of Arthur D. Little).

66. 15 U.S.C. § 80a-3(c)(1) (1976), as amended by Act of Oct. 21, 1980, Pub. L. No. 96-477, § 102, 94 Stat. 2276. Section 3(c)(1) deals with an exemption from the entire 1940 Act, while § 17(b), see notes 64-65 supra and accompanying text, provides an exemption only for the particular transaction under review.

67. "Voting security" is defined in 15 U.S.C. § 80a-2(a)(42) (1976) as any security entitling the owner or holder to vote in the election of directors of the company.

Section 3(c)(1) was amended by the Small Business Investment Incentive Act of 1980 in response to the problem that privately-held investment companies, including venture capital companies, had faced in attracting substantial amounts of capital from institutional investors and other entities without exceeding the 100-investor limit for exclusion from the 1940 Act.\(^6\) Prior to the revision of section 3(c)(1),\(^7\) once a company owned ten percent or more of the outstanding voting securities of the issuing company, beneficial ownership was deemed to have occurred, regardless of the percentage of assets devoted to the investment. The change of section 3(c)(1) is a general revision applying to all investment companies, not just venture capital companies, and is a clear step in stimulating larger amounts of new capital investments.

Even with the revision of section 3(c)(1), however, a dilemma still exists for venture capital companies attempting to remain outside the 1940 Act. Investors in venture capital companies expect that their investments must be held for a period of years before significant capital appreciation is likely to occur.\(^7\) Realization of these gains to the investor from the venture capital company is normally achieved through two alternatives. The venture capital company can in some fashion liquidate, whereupon portfo-

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\(^7\) 1940 Act, ch. 686 § 3, 54 Stat. 797 (1940) (current version at 94 Stat. 2276).
lio values are transferred directly to the investor, or it can create a public market for its securities. Any attempt at going public would require the venture capital company to register under the 1940 Act. Obviously, it would be more beneficial to both the investor and the public for the venture capital company to choose to register under the 1940 Act rather than to choose to liquidate. Virtually every venture capital company, however, chooses not to subject itself voluntarily to the provisions of the 1940 Act.  

IV. The Small Business Investment Incentive Act of 1980

An attempt to alleviate the problems encountered by venture capital companies under section 17 has been made in the Small Business Investment Incentive Act of 1980. As stated in the Senate Report on the 1980 Act, one of the primary purposes of the Act is to “[p]ermit business development companies to raise funds from both public and private sources and remove unnecessary statutory impediments to their entrepreneurial activities consistent with investor safeguards.” Given that the 1980 Act refers specifically to “business development companies” and not venture capital companies, it is necessary to determine if there are any differences between a venture capital and a business development company,

72. See note 8 supra. For example, one of the nation’s most prominent venture capital companies, American Research and Development Corporation, had to merge with another corporation in 1972 rather than trying to continue to operate under the 1940 Act. “I had to terminate [American Research and Development Corporation] because it could not exist under the ‘40 Act. That is the sole reason it does not exist today as an independent company.” 1978 Small Business Hearings, supra note 7, at 58 n.12 (interview of General Georges F. Doriot by Paul H. Dykstra on Nov. 9, 1978).


and to determine exactly what constitutes a business development company.

A. Business Development Companies

One of the original versions of the 1980 Act did attempt to define the precise meaning of a venture capital company.\[75\] The 1980 Act substituted for “venture capital company” the term “business development company.”\[76\] Representatives of the venture capital industry have indicated that the definition of a business development company does encompass most venture capital companies.\[77\] For purposes of the 1980 Act, the two terms can be used interchangeably.

A business development company is defined in section 2(a)(48)\[78\] as any closed-end\[79\] domestic company that is operated for the purpose of investing in securities of the companies indicated in section 55\[80\] and that makes available to these companies significant mana-

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75. 1980 Venture Capital Hearings, supra note 7, at 23-25. The Commissioner of the SEC stated that the definition drafted in proposed H.R. 7554 of a venture capital company is one of the better definitions that he has seen, but that it is really not in the interests of the venture capital community to try and define them because the SEC, through its inspection program, would then have to be in a position of trying to assess for example whether or not a given investment is a turnaround or a leveraged buy-out or whether a company is in a development stage or in need of reorganization. Id. at 69.

76. The reason given for the change was that Congress felt that the term “venture capital company” has different connotations to different persons and may thus lead to eventual difficulties. H.R. REP. No. 1341, supra note 69, at 34, U.S. CODE CONG. & AD. NEWS at 8460; S. REP. No. 958, supra note 74, at 19.

77. H.R. REP. No. 1341, supra note 69, at 34, U.S. CODE CONG. & AD. NEWS at 8460. But see 1980 Venture Capital Hearings, supra note 7, at 121, wherein a member of the National Venture Capital Association stated that the definition of “business development company” is too restrictive and would hinder, rather than facilitate, the flow of needed capital to new and developing companies (statement of Mr. Hagopian).


79. 15 U.S.C. § 80a-5 (1976) defines a closed-end company to be any management company other than an open-end company. An open-end company, commonly called a mutual fund, continually engages in the issuance of its shares and stands ready at any time to redeem them; a closed-end company typically does not issue shares after its initial offering except at infrequent intervals, and does not stand ready to redeem them. Investment Co. Inst. v. Board of Governors, 606 F.2d 1004, 1008 (D.C. Cir. 1979). See also Wellman v. Dickinson, 475 F. Supp. 783, 829 (S.D.N.Y. 1979).

Section 55 is designed to impose investment restrictions on business development companies in order to ensure that companies claiming “business development company” status are actually providing capital and managerial assistance to small, developing companies rather than investing in large, well-established businesses. Under the 1980 Act, business development companies must invest in eligible portfolio companies and make available significant managerial assistance.

1. Eligible Portfolio Companies

Essentially, section 55 requires seventy percent of the value of the business development companies’ investment assets to be composed of securities purchased in nonpublic transactions from “eligible portfolio companies” or their affiliates, securities of “eligible portfolio companies” initially controlled by the business development company, and United States Government securities and high quality debt securities with a maturity of less than one year.

“Eligible portfolio companies,” as defined in section 2(a)(46), are generally those small, developing companies which are in need of capital financing but are locked out of the conventional capital

81. See notes 96-104 infra and accompanying text.
83. Id.
84. Id. at 94 Stat. 2279 (to be codified at 15 U.S.C. § 80a-54(a)(2)).
85. Id. at 94 Stat. 2280 (to be codified at 15 U.S.C. § 80a-54(a)(6)). The venture capital industry has criticized new § 54(a)(6) for failing to take into consideration a venture capital companies’ need to meet current operating expenses because the companies in which venture capital companies invest do not pay out current dividends, see note 23 supra, forcing the venture capital companies to make other investments that will provide operating funds. The investments described in new § 55(a)(6), while they are safe and liquid, generally produce the lowest rate of return. See 1980 Venture Capital Hearings, supra note 7, at 158 (statement of Arthur D. Little).
86. Pub. L. No. 96-477, § 101, 94 Stat. 2275 (1980) (to be codified at 15 U.S.C. § 80a-2(a)(46)). An eligible portfolio company must be a domestic company, and, with one exception, it cannot be an investment company or a company which would be an investment company absent the § 3(c)(1) exemption. (The exception, as found in new § 2(a)(46)(B), id., allows an eligible portfolio company to be a small business investment company licensed by the Small Business Administration and which is a wholly-owned subsidiary of the business development company). The purpose of this restriction seems to be to require business development companies to invest in operating companies rather than in financial institutions. Hence, a bank or insurance company could not be an eligible portfolio company.
markets. The pool of eligible portfolio companies is very broad and consists of three basic categories. First, an eligible portfolio company may not have securities outstanding which are eligible for margin purchase under Federal Reserve Board regulations. The underlying rationale is that companies eligible for margin purchase generally have ready access to the public capital markets and conventional sources of financing. The second category consists of companies which are controlled by the business development company, regardless of the eligibility under margin purchase regulations. This category is designed to cover corporations which are in need of capital, but because of their current financial position may be precluded from conventional financing methods. Finally, the third category consists of companies which the Commission may establish by rule “as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policies and provisions of [the Act].” If it is found that the prescribed requirements of an eligible portfolio company have been too narrowly defined, thereby restricting the flow of capital and the intent of the 1980 Act, the Commission may broaden the category of eligible portfolio companies.

2. Managerial Assistance

Once a business development company has invested in a company properly defined as an eligible portfolio company, it must

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87. It is estimated that there are presently 12,000 publicly-held operating companies and that the definition of “eligible portfolio company” would cover approximately two-thirds, or 8000 of these companies, plus all private companies. 1980 Venture Capital Hearings, supra note 7, at 66.


91. Id. (to be codified at 15 U.S.C. § 80a-2(a)(46)(C)(iii)).

92. Id.

93. Objective factors to be considered by the Commission in broadening the class of eligible portfolio companies are the size of such companies, the extent of their public ownership, and their operating history as going-concerns and public companies. H.R. Rep. No. 1341, supra note 69, at 31, U.S. Code Cong. & Ad. News at 8457.
also “make available significant managerial assistance.”94 A business development company is operated not for current yield but for long-term appreciation;95 hence, it is in the best interests of the business development company to provide guidance and counsel to the investee company and to help the investee company establish objectives, policies and corporate strategy.

Managerial assistance, as defined in section 2(a)(47),96 is comprised of two basic activities.97 First, the term includes “any arrangement whereby a business development company, through its directors, officers, employees, or general partners, offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company.”98 This requires the business development company to have at its disposal the skills and talents necessary to provide significant managerial assistance when such assistance is requested by the eligible portfolio company.99 The business development company need only offer to provide such assistance; if the eligible portfolio company refuses an offer made by the business development company in good faith, there is no violation of section 2(a)(47).100

Second, managerial assistance is provided when a business development company exercises “a controlling influence over the management or policies of a portfolio company . . . acting individually

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95. See note 23 supra and accompanying text.
97. A third activity involves the making of loans to an eligible portfolio company by a small business investment company licensed under the Small Business Investment Act of 1958. Id.
98. Id.
99. The investors relationship with the eligible portfolio company after making the investment normally requires the investor to significantly involve itself with the operations of the investee company. Careful thought must be given to such questions as to what both the investor and the eligible portfolio company seek to accomplish from their relationship. Also, the investor must be willing to act quickly and to implement a specific course of action when the eligible portfolio company encounters any difficulties. See generally Collins & Ruhm, The Legal and Business Aspects of Venture Capital Investing 213 (Practising Law Inst. Pub. No. 208, 1979).
or as part of a group acting together which controls such portfolio company.” 101 If the sole manner in which a business development company provides managerial assistance is by being part of a group in which one of the persons in the group makes assistance available, then the business development company would not be deemed to be making available significant managerial assistance. 102

The precise nature of the managerial assistance provided may take several forms. A business development company may help in finding and selecting for the portfolio company members of the board of directors 103 and key management personnel. Also, a business development company may help establish ties between the portfolio company and commercial and investment bankers. 104

B. Section 57—Transactions with Certain Affiliates

Once a venture capital company elects business development company status, newly enacted section 6(f) 105 provides a general exemption 106 from sections one through fifty-three of the 1940 Act. In place of these sections, the 1980 Act has created a revised regulatory structure. 107 Because the major hardships complained of by venture capital companies have been the restrictions under section

101. Id.
102. Id.
103. In all likelihood, a business development company would try to have one of its own officers, directors, or employees elected to the portfolio companies' board of directors in order to take an active role in management. S. Rep. No. 958, supra note 74, at 17-18.
104. Practically speaking, the nature and amount of managerial assistance provided undoubtedly will vary in accordance with the growth of the portfolio company. Assistance provided to a recently established portfolio company should be greater than in later years as the portfolio company begins to make independent decisions concerning its operations. H.R. Rep. No. 1341, supra note 69, at 33, U.S. Code Cong. & Ad. News at 8459.
106. In order to qualify for the exemption, a company has to elect to be treated as a business development company pursuant to new § 54 (to be codified at 15 U.S.C. § 80a-53), or if the company could be exempt from the term “investment company” as provided in § 3(c)(1) except that it currently proposes to make a public offering of its securities as a business development company, notify the Commission that it intends in good faith to file within 90 days a notification of election to become subject to the provisions of §§ 55-71 of the 1980 Act.
107. Notwithstanding the general exemption provided in § 6(f), new § 59 (to be codified at 15 U.S.C. § 80a-58) applies certain sections of the 1940 Act to business development companies. The applicable sections still in effect are: §§ 1-5, 6, 9, 10(f), 15(a), (c) & (f), 16(b), 17(f)-(j), 19(a), 20(b), 32(a)(i), 33-47, and 49-53.
17, the 1980 Act has attempted to lessen the effect of section 17 as it applies to venture capital companies. Newly enacted section 57\(^{108}\) now provides special procedures designed to facilitate various types of beneficial dealings between business development companies and their affiliates.

Under sections 57(a) and (d), there are still four types of transactions which certain affiliated persons related to the business development company (and certain affiliated persons of these persons) may not enter into with the business development company without prior approval, either from the Commission or from a “required majority”\(^{109}\) of directors of the business development company. The prohibited transactions in sections 57(a) and (d) are identical—the sections differ only as to whom they are applied to and as to how exemptions may be obtained.

1. **Section 57 Prohibited Transactions**

First, an affiliated person cannot knowingly sell any security or other property to the business development company (or a company controlled by the business development company) unless the business development company is the issuer of the security or unless the affiliated person is the issuer and the security is part of a general offering to the holders of a class of its securities.\(^{110}\) Second, an affiliated person cannot knowingly purchase from the business development company (or from a company controlled by the business development company) any security or other property except securities issued by the business development company.\(^{111}\) Third, an affiliate cannot knowingly borrow money or other property from

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109. A “required majority” means both a majority of a business development companies’ directors or general partners who have no financial interest in the transaction, and a majority of such directors or general partners who are not interested persons of such companies. *Id.* at 94 Stat. 2285 (to be codified at 15 U.S.C. § 80a-56(o)). The term “interested person,” as defined in 15 U.S.C. § 80a-2(a)(19) (1976), is very broad and intricate. An “interested person” of an investment company would include an affiliated person. *Id.* For the legislative history of “interested persons,” see North, *The Investment Company Amendment Act of 1970*, 46 NOTRE DAME LAW. 712, 718-20 (1971).


111. *Id.* (to be codified at 15 U.S.C. § 80a-56(a)(2), (d)(2)).
the business development company\textsuperscript{112} (or a company controlled by the business development company), except as permitted in section 21(b)\textsuperscript{113} or in section 62,\textsuperscript{114} or unless the affiliated person is controlled by the business development company. Fourth, certain affiliates\textsuperscript{115} cannot knowingly effect any joint transaction with the business development company in contravention of Commission rules.\textsuperscript{116}

The transactions prohibited in sections 57(a) and (d) are quite similar to the transactions prohibited in sections 17(a) and (d). The only major difference is that acts done without scienter\textsuperscript{117} have been excluded from those transactions prohibited by sections 57(a) and (d).

2. Application of Section 57(a)

Section 57(a) is intended to apply to those affiliates, as enumerated in section 57(b),\textsuperscript{118} who are controlling persons of the business development company or who are very closely affiliated persons of the business development company. Section 57(b)(1) includes any director, officer, employee and member of an advisory board of the business development company and any person who either directly

\begin{itemize}
  \item \textsuperscript{112} \textit{Id.} (to be codified at 15 U.S.C. § 80a-56(a)(3), (d)(3)).
  \item \textsuperscript{113} 15 U.S.C. § 80a-21(b) (1976). Section 21(b) permits the extension or renewal of any loan made prior to March 15, 1940, and also permits an investment company to make a loan to a company which owns all of the outstanding securities of the investment company.
  \item \textsuperscript{114} Pub. L. No. 96-477, § 105, 94 Stat. 2287 (1980) (to be codified at 15 U.S.C. § 80a-61). Section 62 applies § 21 to business development companies along with some additional provisions which are designed to enable business development companies to attract and retain key officers and employees by offering an executive compensation plan.
  \item \textsuperscript{115} This encompasses the affiliates described in § 57(b), see note 122 infra and accompanying text, and the affiliates described in § 57(e), see note 128 infra and accompanying text.
  \item \textsuperscript{117} Scienter or recklessness, in the case of a failure to disclose, requires that "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing." Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977) (citing Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976), vacated, 619 F.2d 856 (10th Cir. 1980) (insufficient time allowed by trial court to permit plaintiff to conduct adequate discovery). "[A] director may have an obligation to maintain an awareness of significant corporate developments and to consider any material, adverse developments which come to his attention." Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973).
  \item \textsuperscript{118} Pub. L. No. 96-477, § 105, 94 Stat. 2281 (1980) (to be codified at 15 U.S.C. § 80a-56(b)).
\end{itemize}
or indirectly is controlled by or is under common control with any of these persons. Section 57(b)(2) includes any investment adviser or promoter of, general partner in, and principal underwriter for the business development company or any person who controls, is controlled by, or who is under common control with any of these persons. Section 57(b)(2) also includes officers, directors, partners or employees of, and persons controlling, controlled by, or under common control with these affiliates.

Sections 57(a) and (b) regulate the conflict of interests problems\textsuperscript{119} that arise in "upstream"\textsuperscript{120} affiliate transactions. As such, the 1980 Act still requires that Commission review and approval of the transaction first be obtained.\textsuperscript{121} The findings required to be made by the Commission are substantially similar to those required in section 17(b).\textsuperscript{122} Consequently, venture capital companies are still faced, at least with respect to "upstream" transactions, with a time-consuming and costly exemption procedure\textsuperscript{123} when the very nature of their operations requires current decisions and financing.

3. Application of Section 57(d)

Newly enacted section 57(d)\textsuperscript{124} applies to transactions between the business development company and certain affiliated persons who are described in new section 57(e)\textsuperscript{125} and who are not subject to the prohibitions of section 57(a).

Section 57(e)(1) includes certain affiliated persons who are non-controlling shareholders of the business development company.\textsuperscript{126}

\textsuperscript{119} See note 54, 60 supra.

\textsuperscript{120} See text accompanying note 46.

\textsuperscript{121} Pub. L. No. 96-477, § 105, 94 Stat. 2281 (1980) (to be codified at 15 U.S.C. § 80a-56(c)).

\textsuperscript{122} There are three evidentiary factors to be considered by the Commission in ruling upon an exemption order: 1) the terms of the proposed transaction must be reasonable and fair and not involve overreaching, 2) the proposed transaction must be consistent with the policy of each registered investment company (or business development company) and 3) the proposed transaction must be consistent with the general purposes of the 1940 Act. 15 U.S.C. § 80a-17(b) (1971); Pub. L. No. 96-477, § 105, 94 Stat. 2281 (1980) (to be codified at 15 U.S.C. § 80a-56(c)).

\textsuperscript{123} See note 65 supra and accompanying text.


\textsuperscript{125} Id. at 94 Stat. 2282 (to be codified at 15 U.S.C. § 80a-56(e)).

\textsuperscript{126} This group is comprised of persons affiliated with the business development com-
Section 57(e)(1) also encompasses directors or executive officers127 of, or general partners in, such five percent shareholder affiliates and persons directly or indirectly controlling, controlled by, or under common control with such five percent shareholder affiliates.

Section 57(e)(2) prohibits transactions between a business development company and any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or an affiliated person of any person directly or indirectly controlling or under common control with a business development company. This would not include, however, the business development company itself or affiliates of a person who is under common control with the business development company solely by reason of being directly or indirectly controlled by the business development company.128

The main distinction between sections 57(d) and (e) and other predecessor sections is that there is no need for Commission approval for an exemption; rather, section 57(f)129 requires that approval of a transaction otherwise prohibited under section 57(d) be made by a “required majority”130 of the directors or general partners of the business development company. The standards of review in section 57(f) are similar to those applied by the Commission in section 57(c)—fairness of the terms of the transaction and consistency with a business development company’s policies.131

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127. Executive officers, as used in § 57(e), Pub. L. No. 96-477, § 105, 94 Stat. 2282 (1980) (to be codified at 15 U.S.C. § 80a-56(e)), means “the president, secretary, treasurer, and any vice president in charge of a principal business function, and any other person who performs similar policymaking functions.” Id.


130. See note 109 supra.

131. The House Committee has stated that it expects the Commission to carefully monitor directorial review and, if it is apparent that § 57(f) is not properly functioning, so as to impair investor protection, then the Committee would take action to reinstate procedures necessary for investor protection. H.R. REP. No. 1341, supra note 69, at 48, U.S. CODE CONG. & AD. NEWS at 8474.

The utilization of directorial review in the promulgation of management policies and ac-
The reason for the substitution of director or general partner review in place of Commission review is that the parties described in section 57(e) are less closely related to the business development company than those parties described in section 57(b); therefore, there exists a lesser potential for overreaching and conflicts of interests. A business development company thereby will be able to enter quickly into certain transactions that previously were prohibited under section 17 without Commission exemption orders. The net result should be enhancement of the flow of equity capital to eligible portfolio companies.

As previously discussed, venture capital companies have found difficulties with the Commission’s exemption procedures for those prohibitions involving joint transactions, as defined in section 17(d). The prohibitions against joint transactions are now found in sections 57(a)(4) and (d)(4). Like section 17(d), sections 57(a)(4) and (d)(4) establish prohibitions against joint transactions only to the extent that a transaction must comply with the rules and regulations the Commission may promulgate for the protection of investors. Section 57(i) provides that until the Commission


132. Id. at 47.
133. See notes 56-60 supra and accompanying text.
135. Id. at 94 Stat. 2282 (to be codified at 15 U.S.C. § 80a-56(d)(4)).
136. Id. at 94 Stat. 2280, 2282 (to be codified at 15 U.S.C. §§ 80a-56(a)(4), (d)(4)).
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adopts rules and regulations under sections 57(a) and (d), their terms will be subject to existing rules under sections 17(a) and (d). Given that venture capital companies have not been able to operate efficiently pursuant to the rules and regulations established by the Commission under section 17(d),venture capital companies will presently remain unable to operate efficiently while complying with the joint transaction prohibitions of sections 57(a)(4) and (d)(4).

V. Conclusion

Although time will determine the full impact of the Small Business Investment Incentive Act of 1980 upon the flow of equity capital to small, developing businesses, it is most likely that a much larger, more stable, and better managed venture capital industry will result. While market conditions and other factors have a greater influence on the ability of small businesses to raise capital than do Commission regulations, small businesses certainly can benefit from an easing of the agency’s rules. Freeing the venture capital industry from some of the constraints of the Investment Company Act of 1940 is an important and positive step towards halting the gradual economic deterioration that has recently developed.

One of the more important revisions made in the 1940 Act concerns the easing of the regulations restricting transactions between an investment company and its affiliates. Newly enacted section 57, modeled after section 17, now governs affiliated transactions entered into by a venture capital company, and at times, substitutes directorial review in place of the lengthy process of Commission review. Although venture capital companies may still face problems in entering joint and joint and several transactions, the

138. See note 59 supra and accompanying text.
139. The effects of government action upon the flow of venture capital is well-documented. For example, when Congress reduced the capital gains rate in 1978 from 49% to 28%, an additional $1.2 billion flowed into the venture capital market. The Economist, Apr. 5, 1980, at 70, col. 3. Conversely, when the Department of Labor issued a proposed ruling in 1979 that threatened to keep pension funds out of venture capital projects, there was a considerable decrease in the flow of venture capital funds. Id.
1980 Act now encourages venture capital companies to enter into affiliated transactions which they previously would have avoided.

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