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Performance-Based Compensation for Investment Advisers to Business Development Companies

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Notes

PERFORMANCE-BASED COMPENSATION FOR INVESTMENT ADVISERS TO BUSINESS DEVELOPMENT COMPANIES

Venture capitalism represents a significant source of capital for small and developing businesses, which in turn form the backbone of America's economy. The Investment Advisers Act of 1940, until its recent amendment by the Small Business Investment Incentive Act of 1980, imposed substantial limitations on the compensation packages which venture capitalists could offer to their portfolio managers. This Note begins with an examination of the limitations imposed by the Act; it then examines proposed Rule 205-3, which the SEC intended to relieve the limitations; finally, the Note examines the statutory reforms contained within the Small Business Investment Incentive Act of 1980.

INTRODUCTION

THE GROWTH of capital resources and the evolution of new business and technology are lagging in the United States today. Critics of the American system blame this situation on the regulation—of, perhaps, over-regulation—of the American business community, and the economy as a whole, by federal and state governments. The high cost of compliance with regulatory mechanisms is thought to reduce the ability of the economy to generate capital, while at the same time increased governmental borrow-
ing has eliminated significant sources of capital which might otherwise have been available to stimulate economic growth. Especially hard hit are small and developing businesses, pivotal elements in the nation's technological advance, which face phalanxes of government regulators and massive barriers to necessary capital funds.

the decline in American innovation was due to government regulation, and that regulation alone has caused the cost of a new pharmaceutical product in the United States to double since 1962. Grabowski, Vernon & Thomas, Estimating the Effects of Regulation on Innovation: An International Comparative Analysis of the Pharmaceutical Industry, 21 J. L. & Econ. 133, 159 (1978).


6. "Small businesses" as used in this Note are those businesses which do not have publicly traded securities and which have net-after-tax income, averaged over the past two years, of $400,000 or less. This conforms to the definition used in rule 205-3; see note 124 infra. An alternative definition offered by the SEC is that the business have assets not exceeding $9 million and a net worth not exceeding $4 million. Both definitions are derived from one used by the Small Business Administration (SBA):

A small business concern . . . is one which: (a) together with its affiliates, is independently owned and operated, is not dominant in its field of operation, does not have assets exceeding $9 million, does not have net worth in excess of $4 million, and does not have an average net income, after Federal income taxes, for the preceding 2 years in excess of $400,000 (average net income to be computed without benefit of any carryover loss). . . .

13 C.F.R. § 121. 3-11 (1979).

7. Examination of the Effects of Rules and Regulations on the Ability of Small Businesses to Raise Capital and the Impact on Small Businesses of Disclosure Requirements under the Securities Acts, Securities Act Release No. 5914 (March 6, 1978), reprinted in [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,530, at 80,150. Small businesses provided nearly two-thirds of the new jobs created in America between 1970 and 1978 and were credited with most of industry's scientific and technological development. SBA Ann. Rep. 3 (1978). One half of the most significant new industrial products and processes were the result of work by firms having fewer than 1000 employees, and nearly one quarter of such innovations were produced by firms having fewer than 100 employees. Small firms were credited with being 24 times more productive of major research and developmental innovations per dollar expended than larger firms. SBA Report, supra note 5, at 259.

The SBA points out that only $3½% of federal research and development dollars were granted to small businesses, yet they produced 50% of the actual development. SBA Ann. Rep. 3 (1978).

8. SBA Report, supra note 5. The Report states:

The registration and reporting requirements of the SEC are prohibitively costly to the small enterprise. In essence, the SEC is doing its job of preventing fraud by preventing all types of small businesses—both good and bad—from access to public markets. Large corporations can afford access to public capital markets but small innovative firms are virtually excluded.
In recognition of these difficulties facing small businesses and the concern evinced by legislative\(^9\) and executive branch studies,\(^10\) many governmental units have adopted or recommended statutory and regulatory changes in hopes of lowering the barriers to development of small companies\(^11\) and consequently increasing technological advances and economic growth.\(^12\) As part of this pattern, the Securities and Exchange Commission (SEC) adopted or proposed several regulations it believed would stimulate eco-

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\(^11\) See, e.g., Revenue Act of 1978 § 402(a), 26 I.R.C. § 1202 (1979)(increasing the capital gains deduction from 50% to 60% was adopted in part to help small businesses attract greater capital); S. REP. NO. 1263, 95th Cong., 2d Sess. 192 (1978). The SBA has called for reductions in taxation on investors in small businesses, reduction in securities regulation affecting investments in small businesses, and a reduction in the governmental paperwork inflicted upon the small businessman. REPORT OF THE SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL FOR SMALL BUSINESSES 3 (1977); U.S. SMALL BUSINESS ADMINISTRATION, GOVERNMENT PAPERWORK AND SMALL BUSINESS: PROBLEMS AND SOLUTIONS (1979).

\(^12\) There are, of course, reasons other than governmental regulation for the absence of investment leading to new capital. Some of these deterrents to new capital formation are: 1) a shift from preference for investment to consumption, perhaps caused by the higher prices of consumer goods during inflationary periods; 2) the failure of firms to devise investment packages, using either internally generated or externally invested capital assets, which prove attractive to investors by providing rate of adequate return for the risk borne; and 3) an increase, perhaps due to a perception by investors of deteriorating global economic conditions, in aversion to high risk investment opportunities. See Von Furstenberg & Malkiel, The Government and Capital Formation: A Survey of Recent Issues, 15 J. ECON. LITERATURE 835 (1977).
nomic development.13 One of these proposed regulations was rule 205–3,14 which was intended to significantly modify section 205 of the Investment Advisers Act of 1940.15

Section 205 prohibits the compensation of registered16 invest-

13. The SEC amended Regulation A to increase the exemption from registration requirements of the Securities Act of 1933 for small offerings of securities from $500,000 to $1,500,000. Increase in Amount of Small Offering Exemption, Securities Act Release No. 5977 (Sept. 11, 1978), reprinted in [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,710 (modifying Regulation A, 17 C.F.R. § 230.254 (1979)).


Following hearings inspired by the pressures of legislative and executive branch studies investigating obstacles to small business development, the SEC also adopted new reporting procedures which simplify disclosure by small businesses. Simplified Registration and Reporting Requirements for Small Issuers, Securities Act Release No. 6049 (April 3, 1979), reprinted in [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,046.

Finally, the SEC adopted rule 242, which allows certain corporate issuers to offer and to sell up to $2,000,000 per issue of their securities to an unlimited number of institutional investors, purchasers of minimum lots of $100,000 of the securities, the issuer's executive officers and directors, and 35 other purchasers. Rule 242, 45 Fed. Reg. 6367 (1980)(to be codified in 17 C.F.R. § 230.242).

These modifications of the status quo are not unopposed. SEC Commissioner Roberta Karmel calls special exemptions for small businesses illogical:

The SEC's primary mandate is investor protection, and it is hard to conclude that investors in small businesses need less protection or less information that [sic] investors in big businesses. If government regulation of small businesses defeats the objective of facilitating capital formation, so does that same regulation of big business.

Cleveland Plain Dealer, Feb. 13, 1980, § F, at 1, col. 1. See also ADVISORY COMMITTEE REPORT, supra note 5, at 511–12.


The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of persons, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.


16. Registration is required of all investment advisers (except those specifically exempted) by § 203 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b–3 (1976). The exceptions to the registration requirements are for:

(1) any investment adviser all of whose clients are residents of the State within
ment advisers through the use of formulae based on the performance of their clients' capital funds. With minor

which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

(2) any investment adviser whose only clients are insurance companies; or

(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under subchapter I of this chapter.

Investment Advisers Act of 1940, § 203(b), 15 U.S.C. § 80b–3(b) (1976). Unless the investment adviser either registers or falls within one of the exceptions above, he or she is prohibited from making use of the mails or any other means of interstate commerce in connection with his or her business. Id. at § 203(a), 15 U.S.C. § 80b–3(a) (1976).

17. An investment adviser is defined by § 202 of the Advisers Act to be:

[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued by or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 78(c) (12) of this title, as exempted securities for the purposes of the Securities Exchange Act of 1934; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.


18. Section 205 provides as follows:

No investment adviser, unless exempt from registration pursuant to section 80b–3(b) of this title, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after November 1, 1940, if such contract—

(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.
exceptions, investment advisers are forbidden to make any contract through which they will receive compensation in proportion to the performance of securities purchased by their clients. The SEC, in rule 205–3, proposed to remove this prohibition from certain investment advisers and permit their compensation to be based on capital performance.

The proposal extended only to investment advisers whose clients fell within the narrowly defined category of “business development companies.” Business development companies—more

Paragraph (1) of this section shall not (A) be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date, or (B) apply to an investment advisory contract with—

(i) an investment company registered under subchapter I of this chapter, or

(ii) any other person (except a trust, collective trust fund or separate account referred to in section 80a-3(c)(11) of this title), provided that the contract relates to the investment of assets in excess of $1 million, which contract provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation or order may specify. For purposes of clause (B) of the preceding sentence, the point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the investment performance of such company or fund is equivalent to that of the index or other measure of performance, and an index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise. As used in paragraphs (2) and (3) of this section, “investment advisory contract” means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account of another person other than an investment company registered under subchapter I of this chapter.


19. Id. For example, Adviser A, managing funds of Client C, who need not fit any particular financial criteria, may receive compensation that charges a percentage of the managed fund’s value at any set period. Although the total compensation will vary as the value of the fund fluctuates with the markets, the variation will not violate § 205. 2 L. Loss, Securities Regulation 1410 (2d ed. 1961). Furthermore, a contract for compensation between the adviser and either an investment company as defined under the Investment Company Act of 1940, (the companion piece of legislation to the Advisers Act), 15 U.S.C. §§ 80a-I to –52 (1976)) or a single investor whose fund under management by the adviser exceeds $1 million may allow for payments based on the performance of an independent standard of measurement.

20. Business development companies were defined in rule 205–3(b):

[b] Business development company. For purposes of this section, “business development company” shall mean any company which

(1) is formed and operated primarily for the purpose of directly acquiring, in transactions eligible for the exemption from registration provided by Section 4(2) of the Securities Act of 1933, securities issued by eligible portfolio companies;

(2) Except as provided by paragraph (e) of this section, has all of its assets invested in securities acquired directly from and issued by eligible portfolio companies;

(3) Beneficially owns at least five percent of all the voting securities (including securities immediately convertible without restriction into voting securities at the
commonly known as "venture capital companies"—represent a significant source of capital funding for new and evolving businesses and as such are an important segment of the community. Investment advisers to these organizations play an important role in the direction and management of the business development company's securities portfolio and, as a consequence, in the management of the companies in which the business development

option of, and without the payment of any additional consideration by, the holder thereof of each eligible portfolio company in which it has an investment: Provided however, that the foregoing condition shall be deemed to be satisfied if the business development company's failure to own at least five percent of such securities results solely from the issuance of additional voting securities by the eligible portfolio company subsequent to the initial investment therein by the business development company;

(4) has issued all its outstanding securities (other than those issued to its officers, directors or employees pursuant to a profit-sharing, stock option or stock purchase plan)

(i) in transactions not involving any public offering of securities;

(ii) in transactions wherein the business development company, and any person working on its behalf, shall have reasonable grounds to believe, and shall believe, immediately prior to making any sale of securities of the business development company, after making reasonable inquiry, either (A) that the purchaser has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment in the business development company, or (B) that the purchaser and the purchaser's representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment in the business development company and that the purchaser is able to bear the economic risk of the investment;

(iii) to persons each of whom, prior to the sale of any securities of the business development company to such persons, have access to, or are furnished with, all material information reasonably necessary under the circumstances to enable such persons to make an informed decision as to an investment in the business development company; and

(iv) to persons, other than the investment adviser and persons associated with the investment adviser, each of whom purchases, or agrees in writing to purchase, securities of the business development company in a unit or units of at least $150,000 which may not be fractionalized or otherwise divided, except as provided in paragraph (f) of this section, and which may not be sold, transferred or otherwise disposed of, by the purchaser in a transaction or transactions involving a public offering of securities, and such person may pay for such securities in cash, or other tangible property, in a single payment of, or in installment payments in the aggregate amount of $150,000 or more (all deferred and installment payments to be due within 12 months from the date of purchase of the securities and evidenced and secured by a full recourse note or notes of the purchaser); and

(5) is not required to be registered as an investment company under the Investment Company Act of 1940.

Rule 205-3(b), 44 Fed. Reg. 37473 (1979) (to have been codified at 17 C.F.R. § 275.205-3), reprinted in 5 FED. SEC. L. REP. (CCH) ¶63,531, at 44,113.

21. The SEC prefers to use a more narrowly defined term for the purposes of this rule. Advisers Release No. 680, supra note 14, at 81,926.

22. For example, more than $170 million in new funds were raised by venture capital firms in 1979, and $216 million raised in 1978. U.S. NEWS & WORLD REP., Dec. 24, 1979, at 75.
company invests.  

The SEC recognized that section 205 of the Advisers Act inhibited the performance of business development companies since it reduced the investment advisers' incentive to perform the additional services required by the special needs of business development companies. The investments made by business development companies are highly speculative; the successful investor is richly rewarded, while the unsuccessful investor may lose the entire investment. Yet the investment adviser to the successful investor was not permitted to join in the benefits of the venture which he suggested. The SEC found that this reduced the willingness of investment advisers to assist business development companies, resulting in turn in a reduction of the flow of capital to small and developing companies.

The SEC sought to correct this problem through the promulgation of rule 205-3, which would have allowed adviser compensation contracts to be based on the performance of the managed capital funds; it hoped thereby to increase the flow of capital into small and developing companies through the lure of increased compensation for investment advisers.

In addition to seeking an increase in the capital funding available for small and developing companies, the SEC had also to uphold the primary purpose of the Advisers Act—the protection of investors from sharp or unscrupulous practices on the part of investment advisers. Rule 205-3's allowance of performance-based compensation is prohibited even where advisers offer their clients rebates for fees collected on advice concerning deals that went sour. Performance-based compensation is prohibited even where advisers offer their clients rebates for fees collected on advice concerning deals that went sour. See Investment Advisers Act of 1940, § 205, 15 U.S.C. § 80b–5 (1976), see text of statute set forth at note 18. Performance-based compensation is prohibited even where advisers offer their clients rebates for fees collected on advice concerning deals that went sour. See Investment Advisers Act of 1940, § 205, 15 U.S.C. § 80b–5 (1976), see text of statute set forth at note 18. See Investment Advisers Act of 1940, § 205, 15 U.S.C. § 80b–5 (1976), see text of statute set forth at note 18. Performance-based compensation is prohibited even where advisers offer their clients rebates for fees collected on advice concerning deals that went sour. 2 L. Loss, supra note 19; Robert Reinhart, Jr., SEC no-action letter (Sept. 21, 1971), reprinted in [1971–72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶78,464.

Advisers Act Release No. 680, supra note 14, at 81,926–27. It should be noted that the SEC, through its allowance of performance-based compensation plans, seeks only to cross the threshold of making advisers available to business development companies, and not necessarily the advice given by any particular adviser. There is no evidence of a connection between performance-based fees and superior investment performance. H. Bines, Law of Investment Management, 5–36 (1978).

Investment advisers are constrained from such practices by both the direct prohibition against performance-based compensation contained in § 205 and the nature of the investment adviser-investor-advisee relationship. The adviser is a fiduciary, required to
based compensation could be justified only so long as adequate protection existed for the investor-advisee.

Following the release of the proposed rule by the SEC in June of 1979, it was roundly criticized by interested practitioners. The criticism was directed toward the probable ineffectiveness of the rule in assisting the flow of capital to business development companies and the inflexibility of the rule’s limitations on portfolio investment by the business development companies involved.

In October, 1980, Congress responded to the capital formation problems of small and developing companies by enacting the Small Business Investment Incentive Act of 1980. The Act contains numerous amendments to the securities laws; the changes in the Advisers Act are intended to eliminate the problems created by section 205’s prohibition of performance-based compensation.

This Note will examine the proposed rule and the 1980 Act in light of the necessity of increasing the available capital for small and developing companies while continuing to maintain the protective standards of the Advisers Act for investor-advisees. The Note will initially discuss the existing environment of the business development company and its investment advisers. Rule 205–3 will then be examined in terms of the effect it would have had upon the ability of business development companies to supply needed capital to small and developing companies, followed by an analysis of the adequacy of protections extended to the investor-advisee by the rule. The Note suggests that, to increase the effectiveness of the SEC’s action, the rule should have been modified so that each adviser would have borne a positive burden of


32. See notes 188–228 infra and accompanying text.
33. See notes 40–82 infra and accompanying text.
34. See notes 83–145 infra and accompanying text.
35. See notes 146–87 infra and accompanying text.
disclosure, each investor of a business development company should have been able to bear the economic risk of investment, and the SEC's proposed alternative definition of portfolio company size should have been adopted. The Note then examines the 1980 amendments to the Advisers Act and contrasts their effect with those of the proposed rule.

I. BUSINESS DEVELOPMENT COMPANIES TODAY

Business development companies, as defined in both rule 205-3 and the amendment to the Advisers Act, are highly specialized, unique investment entities. Unlike the institutional investors—banks, savings and loans, and insurance companies—which possess broadly based sources of investment capital and the ability to place funds in investments with varying risk factors, and the mutual funds or ordinary investment companies, which also have access to the funds of a host of investors and are equally unrestricted in their consideration of risk when investing, the rule limited business development companies to a small number of very wealthy investors and may invest their capital only in highly speculative securities of small and developing companies. Although the 1980 amendments did not restrict the number of investors, Congress did retain the high risk requirement.

Investment in business development companies has become glamorous because of the possibility of investors attaining spectacular profits from a minimal initial outlay. The strategy of these companies is to place capital in small or struggling firms of low

36. See note 168 infra and accompanying text.
37. See notes 172-77 infra and accompanying text.
38. See notes 138-39 infra and accompanying text.
39. See notes 188-248 infra and accompanying text.
40. See note 20, supra.
41. See notes 188-89 infra and accompanying text.
42. Id. Whereas the ordinary investment company may have an unlimited number of investors, the business development company is limited to no more than 100. Rule 205-3(b)(5), supra note 20, at 44,113-3. This section of the rule applies the Investment Company Act of 1940, § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (1976), which excludes from the definition of "investment company" any issuer of securities held by fewer than 100 persons and which does not presently intend to make a public offering. The business development company is really an investment company with limitations on participants and its ability to invest in other than high-risk securities. It can thus be termed a "closed-end" investment company.
43. See WASSERSTEIN, CORPORATE FINANCE LAW, 76-77 (1978); Rollinson, Venture Capital, in THE VITAL MAJORITY: SMALL BUSINESS IN THE AMERICAN ECONOMY 183 (D. Carson ed. 1974). The companies that are most likely to show spectacular profits are those
present value, anticipating that these firms will develop into successful businesses with a much higher value. The increase in the value of securities of the company will provide the business development company's profit when such securities are sold.

There is, however, no guarantee that the investments will prove successful; failure is at least as probable as success. The business development company's investors naturally hope that their successes will more than offset the failures and, to achieve this, seek to improve the management of the investment process.

The investment process may be described as the matching of the risk and return preferences of the individual investors with the risk and return factors involved in a given investment package. Investors have individual perceptions of what constitute acceptable levels of risk and what are acceptable rates of return for their risk-taking. Proper management of this process involves locating investment projects which will match these individual preferences as closely as possible.

The investors in business development companies share one common goal—high returns. While many venture capital projects will involve a high risk factor, this is not a necessary attribute of every business development company investment. The prospect of high returns, however, is usually present.

Investors can increase the potential for higher returns from investment projects through two processes. First, the investor may be able to locate securities which bear market prices below that which the risk factor would indicate is proper. Second, the investor may aggregate diverse investments and by proper management

firms which inherently lend themselves to growth, such as industrial and manufacturing firms. Id. at 188.

44. "Investment risk" is defined as "the variance of realized returns from expected returns." Robinson, Small Business Investment and the Money and Capital Markets, in The Vital Majority: Small Business in the American Economy, 39, 49 (D. Carson ed. 1974). As the variance decreases, the risk will also be reduced.

45. Although the common characteristic ascribed to most venture capital operations is the highly speculative nature of the transaction, the investor is primarily interested in achieving a very high return on an investment which will be realized over a period of time through capital gains. See Rollinson, supra note 39, at 183. This will typically involve taking risks greater than those taken by more conventional financing sources. Id. at 194.


The only circumstance in which the adviser will seriously pursue a low-risk project is when the market incorrectly evaluates the new company and places too low a value upon its securities. See note 43 infra and accompanying text. Such an undervaluation is likely to occur on the securities of a small, privately held developing company because of the absence of efficient information exchange. Id.
reduce the overall portfolio risk to a level below that which the individual components would produce.

The possibility of an "undervalued" security suggests the existence of an inefficient securities market,\(^\text{47}\) where inadequate information regarding individual securities results in investors misperceiving the risk factor associated with such securities, and hence paying either too much or too little for the investment. When such a market exists, an investor must carefully analyze each security for the accuracy of its market price. When the risk is lower than the price warrants, there is an opportunity for a higher return than ordinarily possible at the given risk level. Similarly, an investor must take care to avoid overpayment and reduced rates of return.

"Diversification" is the method of increasing rate of return through aggregation of diverse securities.\(^\text{48}\) Diversification seeks to shelter the total investment by reducing the risk factor for the entire portfolio. This is accomplished by investing in securities whose values do not all behave similarly in reaction to identical

\(^{47}\) The inefficient market theory posits that market prices do not necessarily reflect accurately all the information available about a company at any given moment. Inaccurate valuations placed on securities by the marketplace, due to misinterpretations of available data or failure to instantly and universally assimilate new data, allow securities to be priced at a level either too high or too low for their true risk factor. This permits a higher (or lower) return from a given security than would be possible if the evaluation of market conditions accurately priced the security.

The obverse of the inefficient market theory is the efficient capital market theory. This theory proceeds from the assumption that the market price of a security reflects all the available information regarding the issue and does so instantaneously upon the release of any new data. ADVISORY COMMITTEE REPORT, supra note 5, at xxxii. Under this theory, no expert could discover an undervalued security, or if such a discovery were made, it would immediately be assimilated by the market and built into the price. For a general discussion of the efficient capital market theory, see id. at xxxi-xl; Note, The Efficient Capital Market Hypothesis, Economic Theory, and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031 (1977).

\(^{48}\) Spreading investments through numerous companies reduces the overall investment risk factor of the investment package. Investment risk — the variance of the realized returns with the expected returns — is composed of two elements: the risk intrinsic to the market system involved (systematic risk), and intrinsic to the specific investment (unsystematic risk). Systematic risk may be illustrated by the returns of investors rising or falling in tandem with the movement of the market in which the specific investment is found. Unsystematic risk may be seen when a company fails in otherwise prosperous times or expands in a period of business decline. Id. Theoretically, unsystematic risk (and hence variance of returns) can be reduced by spreading investments through firms operating in different competitive markets.

Systematic risk can be reduced through investments that remain detached from the securities market as a whole. Experimental studies indicate that successful diversification requires placement of capital in at least a dozen different securities. Id.
economic stimuli.\textsuperscript{49} This would be accomplished, for example, by investing in diverse industries or differing regions where the economic factors affecting valuation would vary. This process is especially vital for business development companies where individual securities in the portfolio may have a very high chance of failure.

Diversification, however, is only one of the means used by business developers to reduce overall investment risk; minimalization of risk is also achieved through careful consideration of the management of portfolio companies: the quality of the entrepreneurial abilities of the present firm management and the quality of its product.\textsuperscript{50} These two components are critical to the success or failure of the portfolio company. However, these are difficult factors for the market as a whole to evaluate and may contribute to the undervaluation of the company’s securities.

Finally, minimalization of failure is achieved through active participation of the business developers in the continued financing and direct management of the portfolio company.\textsuperscript{51} Additional capital investments, when needed, help ensure the survival of the small company through temporary economic hardships, while active participation in management may help solve temporary administrative problems.

Thus, increasing the rate of return to the business development company investors is a combination of locating undervalued securities and high risk projects which, through proper management of the selection process and of the portfolio companies themselves, leads to a reduction in the aggregate risk. The result of a success-
ful investment policy will be spectacular profits from minimal investor outlay.

Unfortunately, the individual investor in a business development company may lack the expertise necessary for this undertaking. Consequently, it is advantageous to both the investor and the company to obtain the services of an able individual to perform both the selection process and the follow-up managerial functions. This managerial individual may be given the title of a general partner in a limited partnership, a single general partner in a general partnership, or merely a contractor or employee of the business developers, but this individual's duties will be to locate and investigate potential portfolio companies. He will examine all known and discoverable information concerning the company—its present management, innovations, products, and industrial setting—and evaluate the potential expected rate of return for any investment to be made. He will then weigh this return against the returns desired by the investment group. If the expected return equals or exceeds the return preferences of the investment group, the investment should be made.

The person who serves the business development company in this role is essentially performing the duties of an investment adviser. Whether this person is an "adviser" within the meaning of the Advisers Act and is required to register under section 203 of the Act will determine whether he may receive performance-based compensation, for under section 205, "investment advisers" are barred from receiving any form of compensation which is based on performance of the company's investments.

Sadly, despite the forty year existence of the Advisers Act, no clear determination of the scope of the registration requirements under the Act has been set forth. While some advisers are clearly included within the statute's reach—those who advise more than fourteen individuals while using interstate means and dealing with non-intrastate securities, while some are clearly excluded—attorneys whose securities advice is only incidental to

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52. If a person receives compensation in any form for managing the securities portfolio and advising the purchase or sale of any securities the definition of an investment adviser in § 202(a)(11) of the Advisers Act is applicable. 15 U.S.C. § 80b-2(a)(11) (1976). See note 17 supra.
53. See note 16 supra.
54. See notes 18-19 supra.
55. Note, supra note 17, at 635; see Lovitch, supra note 17.
their profession—a gray area exists in the registration requirements for others, such as general partners in limited partnerships and advisers who are employees of a partnership with more than fourteen partners. It is presently unclear whether a partnership should be considered a single entity and, hence, a single client for registration purposes or whether each limited or general partner should be counted as a separate client. Since business development companies are usually organized as partnerships, the question is significant.

Before the passage of the 1980 amendments to the Advisers Act, business development companies took three different approaches to this problem. First, the investors could limit their numbers to fourteen or less, thereby falling within one of the clear exemptions to the registration requirements (though this assumes that the investment adviser limits any advice to this single group of investors). Second, the investors and their adviser could construe their partnership as a single collective entity and a single client, which placed them within the same statutory exemption. Third, the business development company could accept the concept that each individual investor should be counted as an individual client and refrain from paying performance-based compensation to the adviser. The last alternative, however, was rarely followed.

A. Limiting the Investors to Fourteen or Less

The first alternative, which limits the number of investors to fourteen or less, poses a significant barrier to a business development company's ability to attract large amounts of capital and therefore limits the ability of a business development company to

57. Attorneys, engineers, teachers, and accountants who would otherwise fit the definition of an investment adviser are excluded from the Act's coverage if their advice comes only during the course of their ordinary professional practice. Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b–2(a)(11) (1976).

58. For example, the SEC recognizes hedge fund partnerships as distinct legal entities, but indicates that if the managing partner organizes the partnership, each individual partner is counted as an individual client. Ruth Levine, SEC no-action letter (December 15, 1976). Individual partners will be counted as clients so long as each pays compensation to the managing partner. Id.; Hacker & Rotunda, SEC Registration of Private Investment Partnerships After Abrahamson v. Fleschner, 78 COLUM. L. REV. 1471, 1476–79 (1978).


60. Id.

61. This interpretation is an acknowledgment of the constraints imposed by § 205 of the Advisers Act. See notes 18–19 supra and accompanying text.

become a major source of investment capital. While the possibility that a small group of wealthy investors may collectively create a substantial asset pool does exist, the comparative scarcity of such individuals puts a practical limitation on this idea.

The SEC perceived the need for greater use of the business development technique to promote growth in smaller and developing companies, yet this growth required an increase in the capital investment in the company, which could be realistically accomplished only by increasing the number of investors. This realization did not mesh with the concept of a less-than-fifteen member partnership.

Three factors preclude this form of registration-avoidance from effectively satisfying the need for greater capital formation for small company development. First of all, there is a paucity of available investment advisers deemed acceptable to the investors. Consequently, business development companies have great difficulty in finding capable individuals who are willing to assume the responsibilities of managing both the security portfolio and the companies invested in by the business development company.

The second factor which constrains the effectiveness of this alternative is the potential limitation on the adviser's compensation resulting from the small number of investors involved and their relatively limited resources. Any expansion of the number of investors beyond those of the extremely wealthy, while maintaining the less-than-fifteen per group format, must eventually signal the decline in total value of the group's asset pool. This decline would reduce the group's ability to pay the investment adviser a large salary or to make use of the alternative compensation formulae under section 205, which are keyed to the presence of a sufficiently large asset base. Moreover, both of these methods of remuneration tie the adviser's compensation to the current assets of the business development company while prohibiting the use of the prospect of high future earnings to attract the adviser's attention to the investment group.

The third factor that restricts the effectiveness of the fewer-than-fifteen format is directly related to the decline in asset pool value caused by the limited number of extremely wealthy inves-

63. Id.
64. There were only 4,823 persons registered as investment advisers in 1977, an increase of 781 in one year and 966 more than the total two years earlier. SEC ANN. REP. 234 (1977).
65. See note 19 supra.
tors available for nascent groups. This relative decline in available capital will eventually cause groups to reach a point at which insufficient capital will be available for adequate risk-reduction through diversification.\[^{66}\] It will also force the situation where groups will be unable to assist efficiently the growth of small and developing companies which may require more capital than a single investment group (or even a workable number of investment groups) can generate. While it is not essential that any single developing company be helped by only one business development company,\[^{67}\] there will be a practical limitation on how many groups can work together on a single project, especially if active management assistance of the portfolio companies is required.

These problems would not arise (or would be substantially diluted) if the investment group is allowed to have more than fourteen members.\[^{68}\] This method of avoiding the limitations of the Advisers Act is simply not conducive to fulfilling the needs of small and developing companies.

### B. Investors as a Collective Entity

Interpreting investor groups to be collective entities for the purpose of investment adviser registration under section 203 removes the size limitations discussed in the previous section. Prior to the 1980 amendments to the Advisers Act, this interpretation subjected the business development company and the adviser to the risk of being parties to an illegal contract, should the interpretation have later been held erroneous.\[^{69}\] If the SEC ruled against the firm's interpretation and the adviser had been paid on a performance basis, litigation over the compensation would have

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\[^{66}\] See notes 48–49 supra and accompanying text.

It is essential that the companies which become part of the business development company's portfolio have a high probability of rapid growth and a resultant rapid gain. See note 21, supra. Thus investment is limited to those sectors of the economy where rapidly expansive growth is possible — manufacturing, research, and high-technology — but where high initial capital input is required. With the need for diversification and a minimum of 12 different companies to achieve a safe diversification level it is obvious that business development groups with small amounts of investment capital are virtually impotent.


\[^{68}\] Under rule 205–3, up to 100 investors could have joined in a business development company. See note 42 supra. This would have allowed at least 6½ times as many investors to join under one adviser as would be allowed using the less-than-fifteen exception.

been possible,\textsuperscript{70} and the adviser could have faced SEC disciplinary action.\textsuperscript{71} Despite these risks, many business development companies pursued this course. Needless to say, the SEC did not favor this practice.\textsuperscript{72}

The 1980 amendments to the Advisers Act, however, have now codified the concept of investor groups as collective entities for adviser registration purposes. The limitation extends only to advisers to business development companies, and does not protect adviser-advisee relationships not involving business development companies.\textsuperscript{73}

\section*{C. Registration of the Adviser}

Business development companies which do not avoid registration and the effects of section 205 face a potential dilemma in that they ask for and receive advisory services beyond those normally provided by an “adviser,” yet they are limited in the methods of

\textsuperscript{70} Section 215 of the Advisers Act voids any contract which is made in violation of any section of the Act, including the no performance-based fees portion of § 205. Thus, any compensation paid under such a contract may be invalid. The Supreme Court specifically recognized a right of recission by investor-advisees in Transamerica Mortgage Advisers, Inc. v. Lewis, 100 S. Ct. 242, 249 (1979).

\textsuperscript{71} Section 209 of the Act empowers the SEC to enforce, by injunction, any section of the Act and to bring any violation to the attention of the Attorney General for possible prosecution. 15 U.S.C. § 80b-9 (1976). Section 217 provides for criminal penalties of up to a $10,000 fine, 5 years imprisonment, or both for willful violations of the Act. 15 U.S.C. § 80b-17 (1976).

\textsuperscript{72} The promulgation of rule 205-3 would have avoided this interpretation problem.

\textsuperscript{73} Section 202 of the 1980 Act provides:

Section 203(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(b)) is amended by striking out the period at the end of the paragraph (3) and inserting in lieu thereof the following: “, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election. For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company, as defined in this title, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.”

\textit{Id.}

The amendment exempts from the Advisers Act registration provisions all advisers serving Investment Company Act business development companies. See note 191 infra for the Company Act's definition of "business development company." The amendment also eliminates the uncertainty of investment advisers as to the status of partners, shareholders, and beneficial owners of business development companies as defined in the Advisers Act. See note 190 infra. Such persons are expressly excluded from the calculation of the number of clients for purposes of activating the registration requirement. However, Congress did not intend to clarify this issue for any other potential registrants. H.R. Rep. No. 1341, 96th Cong., 2d Sess. 62 (1980). Thus, for the typical investment adviser, the issue remains unsettled.
compensation open to them. The adviser acts much as an entrepreneur guiding his own business would: actively selecting the securities to be invested in, assisting the present management of the firm in emergencies, and determining the timing of transactions in securities. These functions partially explain the standard structure of business development companies as partnerships with the effective "adviser" serving either as the general partner of a limited partnership or as one of the general partners of a general partnership.

Because they hold these positions of control, advisers to business development companies naturally expect their reward for effective management to be a greater return on their partnership interest. In firms avoiding registration and the effects of section 205, there was no limitation on this return; in the case of advisers who were subject to section 205, however, compensation could not be related to the performance of securities. Therefore, the adviser could not receive a "normal" partnership share based on sales of securities held by the group. This restricted the form of compensation available for such advisers to flat salaries or the alternative fee arrangements of section 205. Neither proved sufficient incentive for capable advisers to increase their participation in business development nor resulted in greater capital formation for small and developing companies.

D. The SEC Response

The SEC was cognizant of the problems of inadequate compensation incentives for advisers to business development companies and of the limitations on normal partnership activity by partners deemed to be advisers. On two occasions it granted exemptions from section 205's prohibitions to business development companies. These individual exemptions were based on each

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75. Although specialists may be employed to perform any or all of the management functions of an investment adviser, these functions are more commonly performed by the general or managing partner of the business development company. See note 47 supra.
76. A common technique used in the partnership setting is an agreement for a greater interest in the partnership earnings for the advising partner than would be proportionate with the adviser's direct investment. See In re Weiss, Peck & Greer, Investment Advisers Act Release No. 623 (March 28, 1978), reprinted in 14 SEC DOCKET 640, 641.
77. See note 19 supra.
firm's demonstration that its arrangement with the investment adviser did not countermand the purpose of the Advisers Act but in fact supported it. Each showed that the primary purpose of the plan was to increase the capital available to small and developing companies and that the compensation arrangement did not create the possibility that the adviser would take unfair advantage of the business development company. Subsequently, the SEC proposed rule 205–3 which incorporated in rule form a general exemption to section 205 similar to those granted individually.

II. RULE 205–3 AND THE PROMOTION OF CAPITAL INVESTMENT IN SMALL AND DEVELOPING COMPANIES

The SEC proposed rule 205–3 in the belief that allowing advisers to share in the gains earned by their investment group would encourage activity in the market and attract more advisers and business developers into the field. The increased interest in business development would then increase the capital available to small and developing companies. Whether the SEC was empowered to do this within the confines of the Advisers Act and whether this expected result was likely to occur are subjects to be analyzed in this section of the Note.

A. The Advisers Act and the Flow of Capital

Although the primary purpose of the Advisers Act has been identified as the protection of the public from fraud and other misrepresentations by investment advisers, section 206A of the Advisers Act empowers the SEC to exempt any transaction from

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81. See notes 146–51 infra and accompanying text.
82. See note 14 supra.
83. See H.R. REP. No. 2639, 76th Cong., 3d Sess. 28 (1940); S. REP. No. 1775, 76th Cong., 3d Sess. 21 (1940).
the provisions of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest. . . ."\textsuperscript{85} Consequently, if the SEC determined that the encouragement of small businesses is a strong public interest, it could lift the statutory or regulatory procedures enacted in or under the Advisers Act to assist these businesses.

Furthermore, the SEC's adoption of this proposed rule would have been consistent with the legislative and executive branch concerns over the role of the investment industry's "vital function of stimulating the flow of capital into industry,"\textsuperscript{86} expressed at the time of passage of the Investment Advisers and Investment Company Acts of 1940. Thus, through its exemptive power, the SEC could attempt to provide additional equity capital for small and developing companies, and thereby effectuate the recognized purpose of the Advisers Act. The remainder of this section will analyze the proposed rule to determine whether it would have achieved this end.

B. \textit{Directing the Flow of Capital by Definitions—"Business Development Company"}

The purpose of rule 205-3 was to facilitate the flow of capital investment into small companies in the developmental stage.\textsuperscript{87} To accomplish this goal, the SEC narrowly\textsuperscript{88} defined the term "business development company" to exclude from the rule's coverage many traditional venture capital activities that fail to respond directly to the need of small company investment capital.\textsuperscript{89} This definition contained three important restrictions: first, the business development company had to be "formed and operated primarily for the purpose of directly acquiring" securities from small and developing companies;\textsuperscript{90} second, the business developers had to purchase at least a five percent voting interest in the small company (the portfolio company);\textsuperscript{91} and, third, the individual inves-

\textsuperscript{85.} \textit{Id.}
\textsuperscript{86.} 86 \textsc{Cong. Rec.} 9807 (1940) (remarks of Rep. Cole).
\textsuperscript{87.} \textsc{Advisers Act Release No. 680, supra note 14 at 81, 927.}
\textsuperscript{88.} See note 20 \textit{supra.}
\textsuperscript{89.} Some venture capitalists have participated in funding large companies which have access to banks or to the public through conventional securities markets. These companies may come to venture capitalists when conventional sources of capital are hard to find, during recessionary periods, or when the individual project under consideration exceeds the available capital.
\textsuperscript{90.} Rule 205-3(b)(1), \textit{supra} note 20, at 44,113.
\textsuperscript{91.} Rule 205-3(b)(3), \textit{supra} note 20, at 44,113-3.
tors had to have a minimum investment in the business development company of $150,000.\(^\text{92}\) Each restriction bore on the business development company's potential to alleviate the capital shortage which confronts small businesses.

1. *Operation Primarily for Direct Acquisition of Small Company Securities*

Since direct acquisition of securities from portfolio companies is the heart of venture capitalism's ability to raise capital needed by small firms, business development companies which seek to operate under rule 205–3 had to be "formed and operated *primarily* for the purpose of *directly* acquiring"\(^\text{93}\) portfolio securities of small and developing companies. Such direct investment of equity dollars into small firms serves as an alternative to conventional lenders and investors.\(^\text{94}\) At the same time, the acquisition of securities in small companies with high growth potential satisfies the investors' desire for long-term, potentially lucrative opportunities. The proposed rule, therefore, aimed at those investment groups which adhere to this behavioral pattern. When the business development company no longer engaged primarily in the acquisition of small company securities, it ceased to serve the purpose of the rule and lost the benefits of the exemption.

When the investors are no longer primarily concerned about working with small and developing companies, it is appropriate to remove a rule 205–3 type exemption. Such a situation arises, for example, if the business development company has been so successful in nurturing the small companies in which it invested to prosperous maturity, that the investors decide to rest on their laurels. When this occurs, the company will no longer have the character of a business development company, having become instead a form of holding company. The business development flavor of the investment company might also be lost if the investors decide that their investment preferences\(^\text{95}\) have changed and begin to invest in mature companies which would not qualify as "small and


\(^{93}\) Rule 205–3(b)(1), *supra* note 20, at 44,113 (emphasis added).


\(^{95}\) A change in the risk-preferences of the investors can occur on either a vertical or horizontal level. If there is a basic change in the level of risk they wish to take, it is considered a vertical change. An illustration of this would be an investment in a mature company, such as IBM or General Motors, which has a lower level of overall risk. A horizontal change, in which the same level of risk is maintained but the preference for the specific investment is changed, would arise from a switch from present small company securities to
developing" under rule 205-3. Although this may in fact benefit the larger company, in that it makes available capital which might otherwise be unobtainable from conventional sources, the investment in mature companies was not the objective of rule 205-3.

Investment in mature companies does not involve the same extreme risk as that in small and developing companies because information concerning the performance and nature of these larger, more established organizations is more available. In addition, management in mature companies usually does not need the active assistance of investment advisers and business developers. Thus, despite the fact that investments in larger, more mature firms may result in innovation, jobs, and other positive elements, any business development company which makes such investments would lose its exemption from section 205.

Rule 205-3's exemption might be explained as an attempt to offset the low value placed on securities of small and developing companies in the marketplace. It provided incentives for those investment groups which seek to invest in companies whose securities are undesirable to the average investor because of insufficient information on their expected performance. Lack of information on expected performance increases the risk factor of the individual company, yet, a major goal of the business development company and its investment adviser is the reduction of these risk factors. Thus, in order to produce the positive effects of rule 205-3—the increase of available capital for small companies—the investment development company must be able to attract knowledgeable investment advisers and reduce the risk. It can be argued that any potential dangers stemming from the establishment of the rule should have been tolerated only so long as the offsetting gains of capital formation for small companies were assured. Under this rationale, the effects of the "operating primarily" language seems correct.

Rule 205-3 also required that the business development company always be "operated primarily" for direct acquisitions of eligible portfolio company securities. This posed a problem in that it reduced the investors' flexibility in making investment decisions.

96. See notes 129-39 infra and accompanying text.
97. See note 51 supra and accompanying text.
98. See note 47 supra and accompanying text.
99. See notes 44-51 supra and accompanying text.
Their investments must fit the description of "portfolio securities" at all times, or their company would not be able to pay performance-based compensation—an event which would raise special problems in the typical partnership situation where the investment adviser is a partner expecting a partner's share of any capital gains. However, problems would arise in any form of organization which paid performance-based compensation since the investment adviser would no longer be entitled to this type of compensation.

Consequently, so long as the investors permitted their investment adviser to receive performance-based compensation under rule 205-3's exemption, they were limited in their choice of investment strategies. They lost the ability to consolidate their position in a portfolio company by purchasing securities after the company goes public. They had to divest securities of successfully developed firms if continued retention would be viewed as changing the character of the business development company. They had to always be "primarily" investing directly in small companies.

Although "primarily" was not precisely defined by the SEC, the informational release containing the proposed rule stated that:

a business development company which had a substantial portion of its assets invested in large, publicly traded companies would no longer be operating "primarily" for the purpose of directly acquiring securities of eligible portfolio companies, and therefore the company would cease to qualify as a business development company under paragraph (b)(1) of the proposed rule.

Since the SEC recognized that this definition might be sufficiently vague to allow payment of performance-based fees where business development companies held many mature securities, it offered an alternative to the "primarily" concept that would require the business development company to sell or otherwise dispose of any security held for ten years. The SEC also proposed a

100. Paragraph (e) of rule 205-3 would have allowed the business development company to maintain limited holdings in interim assets — cash or money-market instruments with a term of one year or less — "provided, that such business development company intends, and reasonably anticipates, to invest or reinvest such assets in securities of eligible portfolio companies." Rule 205-3(e), 44 Fed. Reg. 37474 (1979) (to have been codified at 17 C.F.R. § 275.205-3(e)) reprinted in 5 FED. SEC. L. REP. (CCH) ¶ 56,351, at 44,113-4.


102. Id.

103. Id.

104. Id.
modification of the rule that would permit the business development company to invest up to ten percent of its portfolio in otherwise ineligible securities.\textsuperscript{105} The use of this ten percent limitation may indicate that a similar figure would have been used to limit the concept of "primarily."

A serious problem which resulted from the inflexibility of the rule's restrictions on eligible securities was a potential for conflict of interest for the investment adviser. The adviser, who may have entered into the entire transaction solely because of the performance-based incentives allowed under rule 205–3,\textsuperscript{106} could retain these additional benefits only as long as the company remained within the "primarily" operating restriction of the rule. It is possible, however, that the time would have come when it would have been disadvantageous for the investment group to maintain its status as a business development company. It may be that the securities would have matured and yielded such satisfactory gains that investors would wish to end the speculation process and hold on to their current positions. However, the adviser might be influenced by the prospect of continued performance-based compensation to oppose such a move and encourage continued speculation. This conflict might have caused the adviser to misrepresent the actual position of the investments or the investment market to persuade the investors to continue as before. Such a result would have been completely contrary to the goals of the Advisers Act,\textsuperscript{107} which was intended to protect the investor against the "frauds and misrepresentations of unscrupulous tipsters and touts."\textsuperscript{108} If the proposed rule failed to prevent such conflicts of interest, then it would no longer have been appropriately promulgated under section 206A, which permits the SEC to grant exemptions from the Advisers Act only where "... consistent with the protection of investors."\textsuperscript{109}

Fortunately, the proposed rule contained safeguards against such results. It required the adviser to own an active, significant

\textsuperscript{105} Id. The Commission requested comment on this alternative proposal. When this 10% exemption is coupled with the already existing allowance of paragraph (e) of the rule, see note 95 supra, the investment adviser in the business development company is allowed considerable flexibility to include within the diversification scheme investments in portfolio securities with less risk than the typical small company security. At the same time, there is little reduction of the potential increase in small business capitalization.

\textsuperscript{106} See notes 24–28 supra and accompanying text.

\textsuperscript{107} See notes 146–50 infra and accompanying text.

\textsuperscript{108} H.R. Rep. No. 2639, 76th Cong., 3d Sess. 28 (1940).

interest in the business development company.\textsuperscript{110} This requirement, consistent with the pattern established in the two earlier grants of exemption from section 205,\textsuperscript{111} reduced the untoward effects of performance-based compensation incentives on the adviser. If the adviser should have chosen to continue speculative investments and selected projects which decrease the asset pool, his own interest in that pool would have been reduced and there would have been no performance-based compensation. If, on the other hand, the advisor guided the business development company successfully, he would indeed benefit, but so would the other investors whose interests would also increase. Hence, the problem created by the adviser's self-interest as a compensated employee was mitigated by his self-interest as an investor.

Another safeguard against an investment adviser making a self-interested decision to continue speculation was that each investor in the business development company was required to have a level of sophistication concerning investment\textsuperscript{112} which would have made it unlikely for that investor not to realize his own best interests. Should the adviser attempt to continue speculation once success had been achieved, the knowledgeable investor might easily have chosen to terminate involvement with the group. Since the investments of the past had been successful, liquidation of this interest would not have been difficult.\textsuperscript{113}

It must be noted that the investment adviser's self-interest alone should not be condemned as its presence lay at the very root of the proposed rule. The appeal of the business development field for these advisers was simply the performance-based compensation.\textsuperscript{114} Correspondingly, it was hoped that this exemption would aid the formation of more business development companies, thereby increasing capital in the small business sector of the economy. Effectively understood and controlled, the concept of self-interest, then, could be used to help solve one of the economy's pressing problems. This self-interested decisionmaking was only a violation of section 206A when harm to the advisees resulted. However, this was not likely under this section of the rule.

\textsuperscript{110} See notes 178–82 infra and accompanying text.
\textsuperscript{111} See note 79 supra.
\textsuperscript{112} See notes 159–63 infra and accompanying text.
\textsuperscript{113} This is not true of the investor's interest in general; usually the high-risk factor of the investment in the business development company severely limits the prospective purchasers of such interests. When the business development company has achieved significant success, however, liquidity will increase.
\textsuperscript{114} See notes 24–28 supra and accompanying text.
Thus, insofar as the principle that the business development company had to be "operated primarily" for direct acquisition of securities channeled the flow of capital into small and developing companies and protected against an adviser's abuse of his position, it met the rationale for the proposed rule and the requirements of section 206A.

2. Requirement of a Minimum Investment in a Portfolio Company's Securities

In order to qualify for the exemption of rule 205-3, a business development company had to own a minimum of five percent of the voting securities of each company in which it invested.115 This requirement was derived from the SEC's understanding that the typical venture capital company investing in small and developing companies owned a sufficiently large portion of the portfolio companies to enable it to take an active role, through its investment adviser, in the management of such portfolio companies.116 The Commission believed such control to be a part of the justification for the payment of performance-based compensation under the proposed rule.

This five percent rule, however, limited a business development company's ability to spread its capital through enough companies to ensure proper diversification of the portfolio.117 Since a company may need as many as twelve different security investments to ensure the proper diversification and risk-reduction desired by its investors,118 any requirement of a minimum investment would affect the freedom with which investment advisers could place funds with different companies.

Moreover, there are circumstances where an adviser might have found it desirable, in the absence of this provision, to make an investment below the five percent requirement. For example, two business development companies might collaborate in a joint effort with a single portfolio company.119 In such a case, it might be unnecessary for both companies to hold a large interest in the portfolio company, as one could rely on the other to protect both investment companies through active management participation. The potential return on even a small investment might be attrac-

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117. See notes 50–51 supra and accompanying text.
118. Id.
tive, and much-needed capital would be supplied to a small company. Nonetheless, the SEC precluded this sort of cooperative venture by its minimum investment requirement.

Still, this restriction did not unduly hamper the ability of a business development company to assist in the development of small companies, or to reduce its overall portfolio risk through diversification. The small size of eligible portfolio companies, coupled with the typically large asset pool of a business development company, made any undue burdens on investment unlikely. Most business development companies would have been able to meet the five percent requirement in any company which was eligible for investment under the definition of "portfolio company."

Furthermore, the five percent minimum advanced the rationale for rule 205-3's special treatment of business development company investment advisers—the unique managerial functions of the investment adviser. Since the adviser had to manage both the asset pool and, on occasion, the portfolio company itself, the business development company needed some power to control the portfolio company,\textsuperscript{120} either through an agreement as part of the original funding arrangement or, more typically, through ongoing voting power in the portfolio company's management. Five percent ownership may have, in fact, been too low to ensure this control, rather than too high. The standard appears to have been less a talisman for actual investment by any business development company than a floor below which it was difficult to demonstrate sufficient managerial control to justify performance-based compensation.

3. Minimum Investment Requirement for Individual Investors

The third factor in the SEC's definition of "business development company" potentially affecting the amount of capital available to small and developing companies was the requirement that each investor of the business development company make a mini-

\textsuperscript{120} Obviously, this power can be derived from means other than voting control. The business development company could, for example, lend money to the small firm with conditions attached that would give the lenders some control over the borrower's activities. However, larger venture capitalists — those more likely to have the assets to fulfill the need for significant new capital resources for small businesses — are more likely to use equity financing than straight debt methods of investment. J. DOMÍNQUEZ, supra note 49, at 20-21 (1974). Large venture capitalists favor this method of investment because of their reliance on a high degree of managerial skill in both their investments and the managements of the portfolio companies. \textit{Id.} at 21.
mum initial investment of $150,000.\textsuperscript{121} While this limitation, on the surface, appeared to reduce the ability to raise additional capital from those investors who were either unable\textsuperscript{122} or unwilling to risk so large an initial investment, an examination of the limitation in light of the needs of portfolio companies and the policy of the Adviser's Act shows that the ability of business development companies to increase small company capitalization was not unduly limited.

The amount of funding necessary to establish a sound business development company is substantial.\textsuperscript{123} Diversification for risk-reduction requires the ability to spread investments over several portfolio companies, while the five percent minimum investment rule imposed a minimum entry level for investment. Each of these factors increased the amount of capital necessary for the business development company's internal operations.

More generally, the need for increased flow of capital to small and developing companies required a substantial base of new financial resources. The previous exemptions from section 205 went to firms with sizable asset pools\textsuperscript{124}--the type of business development groups which the SEC sought to promote. Groups of investors with less than $150,000 per individual may not have had a sufficiently large asset pool to play a significant role in small company capitalization.\textsuperscript{125} Thus, they were properly excluded

\textsuperscript{121} Rule 205-3(b)(4)(iv), supra note 20, at 44,113-3.

\textsuperscript{122} To the extent that a person is unable to invest $150,000 in the business development company, the person may be unable to bear the financial risk of any investment in such a venture. This raises the issue of whether such a person should be permitted to invest in such a hazardous investment. See notes 169-71 infra and accompanying text.

\textsuperscript{123} For example, it was the experience of one law firm commenting on the proposed rule that a single client firm required five separate funding transactions during its evolution into a Fortune 1000 company listed on the New York Stock Exchange. The financings involved $1.6 million, $4.5 million, $800,000, $3.4 million, and $14 million, respectively. Cooley, Godward letter, supra note 30.


\textsuperscript{125} This takes into consideration the restriction imposed by rule 205-3(b)(5) on the potential numbers of investors in the business development company. See note 38 supra. Since the group is unable to exceed 100 individuals, efficient risk-spreading requires that each investor contribute more capital to the fund than would be necessary if its numbers were unlimited. Moreover, since the important consideration in diversification schemes is not the individual asset pool of the investors, but the size of the group asset pool, it can be argued that it is unimportant whether the asset pool is made up of many small investors and a few very wealthy individuals or of investors all of whom meet the $150,000 mini-
from the rule's definition because they did not fulfill its purpose.

Finally, the $150,000 minimum investment requirement represented an effort to ensure the continued protection of the investor, by lifting the prohibitions of section 205 only where sufficiently sophisticated investors were involved. Thus, the minimum investment requirement served both purposes of a section 206A exemption: it protected investors while promoting a special public interest—the contribution of new capital to small and developing companies.

C. Directing the Flow of Capital by Definitions—"Eligible Portfolio Company"

In order to further ensure that rule 205-3 would be used only by those advisers and investors who actively invest in small and developing companies, the SEC narrowly defined the category of portfolio companies in which a business development company could invest. Under the proposed rule, the "eligible portfolio company" had to meet three criteria: (1) the company must have had an average annual income over the two year period prior to the initial investment, and (2) at each additional investment the company must satisfy all the conditions described in paragraphs (c)(1)(ii)(iii) and (iv) of this section, and (iv) is not an investment company as defined in Section 3 of the Investment Company Act of 1940: Provided, That the sole basis therefor is not the exclusion set forth in Section 3(c)(1) of such Act.

Rule 205-3(c), 44 Fed. Reg. 37474 (1979) (to have been codified at 17 C.F.R. § 275.205-3(c)), reprinted in 5 Fed. Sec. L. Rep. (CCH) ¶56,351, at 44,113-3.
ceding the initial investment which was less than $400,000130 (An SEC alternative proposal was to restrict eligibility to portfolio companies with net worth of $4 million and total assets of $9 million);131 (2) the portfolio company could not have previously made a public offering of its securities;132 (3) the portfolio company could not be an "investment company" as defined in the Investment Company Act.133 Each of these factors served to limit the effects of rule 205-3 to investments in those small and developing companies which were perceived by the SEC and other regulatory agencies to be in need of assistance.

1. Restrictions on Portfolio Company Size

The most effective assurance that the ultimate beneficiaries of this rule would be the small and developing companies which required increased capital was the size limitation of eligible portfolio companies. Rule 205-3 required that the portfolio company be a firm which, in the two years preceding the initial business development company investment, had an average annual net income of less than $400,000.134 The rule did not prohibit additional investments of capital in the small company after it exceeded the initial income limitations135 and therefore did not limit active assistance of the portfolio company after the initial contact.

However, the SEC's exclusive reliance on income in defining portfolio company size may have raised potential difficulties. Such a definition ignored the possible deflection of capital from small companies to larger ones which were not the intended recipients of the rule's benefits. A larger company, which had suffered two consecutive years of low profits, would fit the definition as proposed, assuming that it was neither publicly held nor an investment company.136 Yet this firm might have been able to seek capital effectively from alternative markets—such as conventional lenders—because of its large net worth or net asset pool. It, however, would not have been the type of company for which the SEC

130. Rule 205-3(c)(1)(i), supra note 124, at 44,113-3.
133. Rule 205-3(c)(1)(iv), supra note 124, at 44,113-4.
135. Id. at 81,930.
136. These were requirements of rule 205-3(c)(1)(i), supra note 124, and rule 205-3(c)(1)(iv), supra note 124, respectively.
perceived a special need for business development company assistance. Thus, the present definition of "eligible portfolio company" was overbroad.

The SEC suggested an alternative definition, which based the eligibility of a portfolio company on its net worth and total asset value. Net worth could not exceed $4 million, and total asset value could not exceed $9 million. Reliance on these standards, rather than net income, would have eliminated the possibility of a large firm taking advantage of the rule. Only if a large firm's asset pool had been reduced would it be able to fit into the eligible category. Thus, the alternative definition more closely followed the aim of the SEC to facilitate the increased capitalization of small companies, and should, therefore, have been adopted in lieu of that originally proposed.

2. Restriction to Privately Held Companies

The definition of an eligible portfolio company precluded concurrent or previous public offerings of the small company's securities. This restriction was not unprecedented — venture capital companies have traditionally dealt with privately-held firms which lack access to the capital available in the public securities markets. Nevertheless, it must be recognized that some small companies have made public offerings and would have been denied the benefits of rule 205-3. Moreover, it is likely that their securities would have a low present value due to the high-risk level associated with the typical portfolio company investment of business development companies. The SEC, however, believed that these publicly traded firms should not be included in the business development company's prospective investments. It was argued that despite the low present value of the securities, the publicly traded firms could seek investor interest, and hence capital, through means foreclosed to the privately held firms which were the target of rule 205-3. Although there might have been individual cases of

137. See note 89 supra and accompanying text.
138. Advisers Act Release No. 680, supra note 14, at 81,929-30. This standard is also based on the SBA's definition of "small business concerns."
139. Id.
140. Rule 205-3(c)(1)(ii), supra note 124, at 44,113-4.
142. See notes 43-45 supra and accompanying text.
143. The publicly traded company has access to the public securities markets and therefore is more visible to experts other than investment advisers to business development
publicly traded firms disadvantaged by this restriction, it carried forward venture capital's established predisposition for private companies, and would not have substantially impaired investment in small companies.

3. Restriction on Investment in Investment Companies

The SEC's concern for small businesses in their developmental stages which are unable to obtain financing from public and institutional financial markets did not extend to investment groups, except to the extent that those groups foster capital investment in small and developing companies. It was not surprising, therefore, that the rule prohibited investment of business development company assets in the securities of other investment companies.\textsuperscript{144} Permitting this type of investment would not have directly increased the capital available to any of the SEC's target small companies. Even if the portfolio investment company used its assets to capitalize small businesses, it would only have been acting as an intermediary for funds which the original business development company could have provided directly. This would also have reduced the active control of the business development company's investment adviser over investment management and obviated the basis for the adviser's exemption from section 205.

Permitting another investment intermediary to have portfolio company status might also have led to an evasion of rule 205-3 restrictions by both the investment adviser and the investing business development company. The investors of the business development company could have organized a second "portfolio" investment company which would not have conformed to rule 205-3 standards for investment companies, but which the investment adviser could have managed while continuing to receive performance-based compensation from the parent. Although the "portfolio" investment company might have technically conformed to the size requirements of the rule,\textsuperscript{145} and therefore be a "small" business, it was obviously not the type of business which the SEC wanted to provide with increased capital flow. The prohibition against portfolio company status for another investment companies. This visibility ought to reduce the perceived risks of the firm which in turn may increase the possibilities for attracting investors. See note 46 supra.

\textsuperscript{144} This provision extends to hedge funds or other business development companies, which are excluded from coverage by the Investment Company Act only by the effects of § 3(c)(1) of that Act. Advisers Act Release No. 680, supra note 14, at 81,929.

\textsuperscript{145} See notes 130-31 supra and accompanying text.
company was an attempt to avoid such abuse of the exemption and to maintain the small business capitalization function of the rule.

Thus, it appears that rule 205-3 did adequately consider and control the loopholes existing in its exemption from section 205 of the Advisers Act for those business development companies and advisers who would facilitate the flow of capital to small and developing companies. It remains to be determined whether the rule provided adequate protection for the investor-advisees, which was the intent of the Advisers Act and the specific requirement of section 206A.

III. THE CONTINUING PROTECTION OF INVESTORS

The essential purpose of the Investment Advisers Act, and hence any regulation promulgated under its authority, is "to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts...." 146 The Act makes such maneuvers by investment advisers illegal, 147 requires advisers involved in interstate commerce to register with the SEC, 148 and empowers the Commission to deny registry (and hence legal status) to any person convicted of felonies involving the sale of securities 149 or other willful violations of the various securities laws. 150

Section 205 of the Advisers Act, intended to discourage undue risk-taking by investment advisers, until the 1980 amendments, prohibited contracts between advisers and advisees under which the adviser received performance-based compensation. 151 Rule 205-3, however, flew in the face of this strong congressional prohibition against compensation plans which give rise to adviser manipulation of investor-advisee assets for selfish gain. Thus, the rule was appropriate only if safeguards were established that would provide the investor-advisee with adequate protection against wild speculation by the adviser. 152

To accomplish this protection, the SEC adopted five conditions which had to be satisfied before rule 205-3's exemption

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150. Id. at § 203(e)(4).
151. See note 18 supra.
would operate: (1) the investors in the business development company had to meet a test of knowledgeability;\(^{153}\) (2) the investor had to have access to material investment information;\(^{154}\) (3) the investor had to make a minimum investment of $150,000 in the business development company.\(^{155}\) Each of these three safeguards had to exist at the time the investor entered into the investment group; the presence or absence of an investment adviser at that time was immaterial;\(^{156}\) (4) the investment adviser was required, upon his entry into a performance-based fee contract, to have an investment interest similar to that of the investor-advisee, thereby acquiring an actual stake in the venture beyond the advisory fee;\(^{157}\) (5) the advisory fee had to be calculated by a formula including losses as well as gains.\(^{158}\) In this section of the Note, each safeguard will be examined in turn.

A. Knowledgeability of the Investors

The proposed regulation, requiring the investors in the business development company to meet a knowledgeability test, prohibited the company from issuing its securities to any purchaser whom it did not have "reasonable grounds to believe, and shall believe . . . has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment in the business development company."\(^{159}\) If the individual investor lacked this level of knowledgeability, the rule permitted an evaluation of both the potential

\(^{153}\) Rule 205-3(b), \textit{supra} note 20, at 44,113.

\(^{154}\) Rule 205-3(b)(4)(iii), \textit{supra} note 20, at 44,113-3.

\(^{155}\) Rule 205-3(b)(4)(iv), \textit{supra} note 20, at 44,113-3.

\(^{156}\) Rule 205-3(a) did not extend its exemption to existing venture capital groups unless every member of the group — past and present — met the definitional requirements. Rule 205-3(a), \textit{supra} note 20, at 44,113.

\(^{157}\) Rule 205-3(d)(1), \textit{infra} note 178, at 44,113-4.

\(^{158}\) Rule 205-3(d)(2), \textit{infra} note 183, at 44,113-4.

\(^{159}\) Rule 205-3(b)(4)(ii), \textit{supra} note 20, at 44,113-3. This standard of knowledgeability was also used in rule 146 of the Securities Act of 1933, 17 C.F.R. § 230.146(d)(2), making interpretations of rule 146 relevant to rule 205-3. Advisers Act Release No. 680, \textit{supra} note 14, at 81,928. The burden of determining knowledgeability will fall on both the investment adviser and the business development company promoters. The adviser must make an independent appraisal of the investors' knowledgeability because it is the adviser who is expressly forbidden under § 205 from entering into a contract with a performance-based fee. The investment sponsors must also have reasonable grounds for believing investors are knowledgeable. Furthermore, if they plan to employ the services of an investment adviser at a date following the initial formation of the business development company, the requirements of the proposed rule must be met at the time of the initial securities sale or distribution.
investor and the representative to be made for this knowledgeability, provided that the investor was "able to bear the economic risk of the investment."\textsuperscript{160}

This required knowledgeability concerning the risks of investment in the business development company included, by implication, the ability to judge the value of the company's investment adviser, yet there never have been criteria by which the SEC or other regulatory bodies measure adviser competence.\textsuperscript{161} Although proposals have been made for the establishment of training or quality standards, none has been enacted.\textsuperscript{162} Consequently, evaluation of the investment adviser's competence remained the investor's responsibility.

Knowledgeability provided the investor with a safeguard against the behavior of the investment adviser in that the investor could judge independently (or with assistance of a representative) the business development company's risk level and determine its relationship to the investor's own risk-preference.\textsuperscript{163}

\textbf{B. Investor Access to Material Information}

Rule 205-3 required that the business development company issue its securities only to investors who "... have access to, or are furnished with, all material information reasonably necessary under the circumstances to enable such persons to make an informed decision as to an investment in the business development company."\textsuperscript{164} This portion of the rule was clearly designed to protect the investor from blindly risking his capital in the investment group. It was a necessary adjunct to the requirement of knowledgeability, since even those investors who were generally knowledgeable about investment strategy and market conditions were incapable of making sound, independent judgments of the quality of an investment about which they were ignorant. This concept was consistent with the general securities law policy of promoting

\begin{footnotes}
\footnote{160. Rule 205-3(b)(4)(ii), \textit{supra} note 20, at 44,113-3.}
\footnote{162. \textit{Id.} at 77-80. See \textit{Legislative Proposals Concerning Regulation of Investment Advisers}, 332 Sec. Reg. & L. Ref. (BNA) E-1, E-5 (Dec. 17, 1975), in which the SEC asked Congress for authority to promulgate standards. An objective of these financial responsibility rules would be to ensure the existence of the investment adviser to provide the requisite continuity for long-range investment advising. \textit{Id.}}
\footnote{163. \textit{See} notes 95-96 \textit{supra} and accompanying text.}
\footnote{164. Rule 205-3(b), \textit{supra} note 20, at 44,113.}
\end{footnotes}
an informed investment public;165 disclosure, rather than close regulation, is the preferred procedure.

The rule did not state precisely what “material information” had to be available or provided to the investor—an ambiguity which followed the SEC’s view that “materiality” is a non-quantifiable concept, judgmental in nature and impossible to translate into numerical formulae.166 The investor and business development company had to rely on past interpretations of “materiality”167 rather than on standards delineated by the rule. In this respect, the business development investor was in the same position as any other investor.

The proposed rule may be criticized for its failure to impose a complete burden of disclosure upon the business development company and its investment adviser. The SEC could have required that all material information be provided to the investor; instead it had divided the burden, requiring the investor to acquire that information which was accessible. This safeguard was weaker than a requirement that the investor be provided with all material information, and since rule 205–3 benefited the investment adviser as well as small businesses, it would seem appropriate to have placed any additional burdens arising from the need to protect the investor upon the adviser rather than the investor. The

165. The Advisory Committee on Corporate Disclosure recommended that the SEC adopt the following statement of objectives:

The Commission’s function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment, and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

ADVISORY COMMITTEE REPORT, supra note 5, at D-9.

166. Cf. Blackstone, A Roadmap for Disclosure vs. a Blueprint for Fraud, 26 U.C.L.A. L. REV. 74, 79 (1978) (discussing disclosure under the Securities and Securities Exchange Acts). In response to the idea of setting up materiality guidelines for disclosure by public companies, the SEC staff concluded that detailed guidelines are not feasible and that specific rules tend to become a blueprint for fraud. Id. at 74.

167. The materiality concept effectively limits the amount of information which must be disclosed to investors under the securities laws. Some information is obviously needed to allow the investor to make an informed investment decision. “Full disclosure,” however, is not truly possible due to the prohibitively high costs in time and expense for the discloser and the unmanageable task of the investor actually digesting the material. Hewitt, Developing Concepts of Materiality and Disclosure, 32 BUS. LAW 887, 892 (1977).

The definition of “material” is not fixed; it is a matter of case-by-case analysis. However, the standard against which factual circumstances are tested for “materiality” was established by the Supreme Court in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976): “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. at 449.
Commission, then, should have required that the investors be provided with all material information reasonably necessary to make an informed decision.

This proposal would have withstood both cost reduction and cost allocation analysis. The cost of each investor individually obtaining the requisite information to make a knowledgeable judgment regarding the investment would always exceed the cost of the adviser gathering the information and providing it to the investors, regardless of whether the business development company was in its organizational phase or had matured. In the organizational period, each investor would need approximately the same amount of information (for example, the prospective risk factors of the investment packages and the abilities of the investment adviser). This information should have been provided, not merely made accessible. At a later point in the company’s development, the adviser would be the most informed individual and independent investigation would be more costly, and less likely to find all the facts, than consultation with a competent adviser.

Placing the full burden upon the adviser would have made any subsequent investigation into the completeness of available material information easier, while reducing the cost of informing the investor and enforcing the regulation. Under the rule as proposed by the SEC, the factfinder in any action in which the knowledgeability of the investor was significant would have been forced to look at the information which was provided as well as the information which was accessible—an inquiry which would have involved determining boundaries for the concept of “accessibility.” Under the proposed modification, however, the factfinder need only have examined the information provided to determine its adequacy.

The requirement that the investor be informed stemmed from the release of the investment adviser from the prohibitions of section 205. Although it was hoped that the ultimate benefit of the exemption would fall upon small and developing businesses, the initial benefits would have been felt by investment advisers who would receive compensation exceeding that previously allowed. It would have been appropriate, then, to place any added costs re-

168. Cost reduction analysis is based on the concept that the preferred form of regulation is that which bears the lowest cost to the system as a whole. If Regulation X will cost, for a single transaction, $10,000 to the company, $50,000 to the investor, and $50,000 to the government, it is less attractive than Regulation Y, which will cost the company $80,000 without direct costs to the others.
sulting from this exemption upon the direct beneficiary, as under a cost allocation theory. Such an allocation—requiring the investor to be informed at the cost of the adviser—would have contributed to the safeguards against abuse of the rule 205–3 exemption.

C. The Investor’s Minimum Investment

Rule 205–3 required purchasers of an interest in business development companies to invest at least $150,000 (paid either at the time of initial purchase or within twelve months of that time).\(^\text{169}\) This served as a crude safeguard against risk mismatch by the investor, and was based on the dubious presumption that persons with $150,000 to invest were seeking (and were appropriate investors in) the high-risk securities to which the investment adviser would commit the business development company’s funds.\(^\text{170}\) Independent wealth was also presumed to indicate the ability either to make an independent investment decision or to employ capable representatives,\(^\text{171}\) and thus increase the likelihood that the investor would be able to preserve his or her position even in the face of managerial abuse by the adviser. Yet, the language of the proposed rule did not guarantee investor affluence. While required to make a $150,000 investment, the ability of the investor to bear the economic risk involved in the venture was not necessarily apparent; this investment may have been the investor’s only asset,

\(^{169}\) Rule 205–3(b), supra note 20, at 44,113.

\(^{170}\) Minimum wealth level does not indicate the ability to perceive the risk of investment, nor does it accurately identify the risk level at which a person should be investing. For example, an investor with a present net worth of many millions of dollars, but without any current income sources, should be concentrating his or her investments on current income production, not high-risk securities.

The minimum wealth standards of rule 205–3 would have failed to protect an investor against such a mismatched risk in a situation where the investment adviser or the business development company was actively involved, through the sale of the company’s securities, in promoting the mismatch.

It must be recalled, however, that the wealth requirement did not operate in a vacuum, but only as a correlative requirement to that of knowledgeability. Under rule 205–3, the investor must have been either self-knowledgeable or have had the services of a personal representative who provided the requisite knowledgeability. See notes 159–63 supra and accompanying text. Therefore, an investor had to have the ability to determine personally the appropriate risk level at which investments were made. Thus, in conjunction with knowledgeability requirements, minimum wealth requirements limited the entry of investors who truly lacked the ability to cushion themselves against loss. See notes 159–60 supra and accompanying text.

\(^{171}\) Employing a representative was permitted, see note 20 supra.

\(^{172}\) “Economic risk,” as used in (b)(4)(ii), was an additional standard to be met by those investors who were not personally knowledgeable. See note 20 supra. The SEC, however, did not define the standard to be used in testing the ability to bear economic risk.
leaving no reserve should the investment fail. This possibility vitiates the presumption that an investor's sizeable investment always indicates some extra independent judgmental capability regarding the investment, and therefore weakened the value of this safeguard against adviser abuse of the exemption from section 205.

This weakness was accentuated by the failure of the rule to prohibit leveraging\textsuperscript{173} by the investor. Under the rule, it was possible for the knowledgeable investor to raise $150,000 by borrowing against other assets, including such basic assets as a home or life insurance policy. A subsequent collapse of the investment could have resulted in permanent economic harm to the investor relying upon such basic equity.

It is not the customary duty of the SEC to protect investors against the rash mistakes or miscalculations which may be the reason for the loss to the leveraged or otherwise undercapitalized investor. It is possible, however, that an adviser's abuse of the exemption from section 205 may have caused such a loss by acting in the wildly speculative way which initially led to the adoption of section 205.\textsuperscript{174} Thus, the proposed rule could have led to significant economic injury to an investor—a result repugnant to section 206A. Because of this possibility, the SEC should have changed the requirements of minimum investment assets to require that all investors be able to bear the economic risk of the investment without leveraging and overstretching personal assets.

It should also be noted that some investors were already protected by this proposed modification; those investors who did not meet the self-knowledgeable test must have been able to bear the economic risk of their investment decision, leaving only those individuals who were deemed self-knowledgeable to suffer the consequences of overstretching their personal asset pool.\textsuperscript{175} Even though it was not obvious how this differentiation would aid additional capital formation for small companies, the SEC failed to offer an explanation.\textsuperscript{176}

\textsuperscript{173} Leveraging is "the use of borrowed capital to increase the profitability of the equity, or shareholder's interest." H. HOAGLAND & L. STONE, REAL ESTATE FINANCING 118 (1973).

\textsuperscript{174} See note 146 supra.

\textsuperscript{175} These people are apparently excluded from the requirement of being able to "bear the economic risk" by virtue of their acknowledged independent ability to judge the risks involved. Any mismatched risk which takes place results from their own choice, rather than through outside influences.

\textsuperscript{176} Even if there were some small incremental increase in capital formation due to the proposed language, this would not in itself satisfy § 206A's requirement that the investor be
At the time the Advisers Act was enacted, Congress expressed some concern for those investors who were not truly wealthy.\footnote{If there was to be a distinction in the regulatory scheme between those who are wealthy and those who are not, it would seem appropriate to have given any additional protection to the less affluent. The rule's effect, however, was in diametric opposition to this goal; it should have been modified to require that all investors be able to bear the economic risk of their investment.} If there was to be a distinction in the regulatory scheme between those who are wealthy and those who are not, it would seem appropriate to have given any additional protection to the less affluent. The rule's effect, however, was in diametric opposition to this goal; it should have been modified to require that all investors be able to bear the economic risk of their investment.

\section*{D. The Adviser's Minimum Investment}

The requirement that the investment adviser purchase and maintain an investment of at least $150,000\footnote{Rule 205-3(d)(1) provided:}
acted as another protection against misuse of the managerial position. This requirement significantly altered the relationship of the adviser to the advisee, as the investment adviser could no longer escape from poor investment unscathed; he would now suffer losses as well as enjoy gains. Furthermore, the requirement that the adviser have no less of an investment than one percent of the cash and other tangible property invested by the other investors forced his equity position to increase along with the other investors. This should have inhibited wild speculation.\footnote{44 Fed. Reg. 37474 (1979)(to have been codified at 17 C.F.R. § 275.205-3(d)(1)), reprinted in 5 FED. SEC. L. REP. (CCH) ¶67,351, at 44,113-4.}
It should be noted that this provision was a significant modification of the Investment Advisers Act, as the Act does not contain any financial responsibility requirements for advisers.\textsuperscript{180} Although the SEC has asked Congress to promulgate standards for financial responsibility, this has not yet been done. However, the SEC believes that such standards are essential, arguing that "a primary objective of any financial responsibility requirement under the Advisers Act would be the existence of the investment adviser as a going concern to provide the requisite continuity to long-range investment planning."\textsuperscript{181} So, the requirement that advisers operating under rule 205–3 maintain a stake in the venture was designed to ensure this continuity of advice and control over investment planning. Continuity is especially crucial for business development companies, which rely upon their adviser to manage both their long-term investments and the portfolio companies when necessary.

The weakness in the proposal lay in its potential impact upon younger and less financially secure investment advisers. The minimum investment requirement might have excluded them from working with business development companies operating under rule 205–3, since their inability to raise the required investment funds would make them ineligible. While this hardship might have been mitigated by allowing them, within the bounds of the rule as written and the modified language suggested in the previous section,\textsuperscript{182} to leverage their investment with borrowed funds, this would not have eliminated the problem. Moreover, the significant protection to all the investors which resulted from the adviser's minimum investment was simply too important a safeguard against adviser abuse of rule 205–3 to eliminate, even for the less wealthy advisers.

\textsuperscript{180} Ahart, \textit{supra} note 161, at 76.

\textsuperscript{181} Legislative Proposals Concerning Regulation of Investment Advisers, \textit{supra} note 162, at E-5.

\textsuperscript{182} See note 173 \textit{supra} and accompanying text.
E. Calculation of the Adviser's Compensation

The proposed rule required that any performance-based compensation paid to an adviser be determined by netting the gains against all realized and unrealized losses. The fee could be calculated on the basis of actually realized gains or of realized and unrealized gains; in either case, however, all losses, realized or not, had to be counted. Thus, sale of a highly successful security providing large capital gain to the company asset pool would be offset for compensation purposes by any losses in securities presently held by the business development company. Consequently, the adviser could not manipulate his compensation by selling successful securities while "hiding" unsuccessful investments. The rule required that the value of the retained securities be ascertained through an independent appraisal. This method of calculation ensured that the adviser would not receive compensation for gain on one security if such gains insufficiently offset existing losses.

These procedures did not preclude the possibility of perform-

183. Rule 205-3(d) provided:

(2) Any computation of net capital gains or net capital appreciation for purposes of determining compensation of a type described in paragraph (a) of this section shall be made net of all realized capital losses and unrealized capital losses and unrealized capital losses (capital depreciation) of the business development company during the period for which the computation is made; and

(3) Any compensation paid pursuant to paragraph (a) of this section shall be based on a written valuation of the business development company's assets which is prepared or reviewed by a qualified independent appraiser (i) who is not (A) a person associated with the investment adviser or (B) a person otherwise providing services to the investment adviser, pursuant to any agreement or understanding, and (ii) who certifies in writing to the business development company that the valuation is fair and reasonable.


184. Id.

185. Id.

186. For example, suppose the business development company in which the investment adviser has a performance-based compensation contract has twelve different securities. Suppose further, that it sells two of this group at a net capital gain of $200,000 and one at a net capital loss of $10,000. Finally, suppose that of the nine other holdings, three have appraised valuations above their purchase price totalling $50,000, three have neither gained nor lost value, and three have lost value totalling $200,000. In calculating the adviser's compensation, the company could either count only the realized gains or count both the realized and the unrealized gains. The former totals $200,000; the latter totals $250,000. If losses could be ignored, these values would form the basis of the consideration. If only realized losses were offset, the compensation would be calculated on $190,000 or $240,000, respectively.

However, the rule required calculation of all losses, realized and unrealized. Thus, the $200,000 paper losses must be offset as well, reducing the basis for compensation to either a negative factor of $10,000 or a positive value of $40,000.
ance-based compensation being paid in one year, based on successful growth in the investments held, while events in the next year cause the investments to decline in value. Although this was a risk which is faced in designing any compensation plan, it did not significantly weaken the safeguards against adviser abuses. When combined with the other safeguards—knowledgeability, access to information required for informed decisionmaking, minimum investor investments, and minimum adviser standards\(^{187}\)—the netting process appeared to provide adequate assurances against investment adviser abuse of rule 205-3's exemption.

IV. The Small Business Investment Incentive Act of 1980

Congress has responded to the need for capital formation in business with its enactment of the Small Business Investment Incentive Act of 1980.\(^{188}\) The Act contains three amendments to the Advisers Act\(^{189}\) which, in effect, permit the payment of performance-based compensation to investment advisers of business development companies. This section of the Note will examine and contrast the statutory changes with those discussed earlier with regard to rule 205-3.

A. The Promotion of Capital Investment in Small and Developing Companies

In circumscribing the availability of performance-based compensation, Congress, like the SEC, has adopted a definitional approach. The terms "business development company" and "eligible portfolio company" are defined so as to allow such compensation only for the advisers of those investment groups which directly facilitate the capital formation of small, developing companies. Congress's definitions, however, are far less restrictive

\(^{187}\) See notes 159–82 supra and accompanying text.


than those employed by the SEC, and result in a far broader class of eligible portfolio investments.

1. "Business Development Company"

The Advisers Act now contains a definition of "business development company" in section 202(a)(22). This definition is derived from the new definition of a business development company contained in the Investment Company Act, but differs from that contained in its sister act in three respects: it removes the requirement that the business development company be a closed-end investment company that has elected to be covered by the newly-enacted sections 55 through 65 of the Investment Company Act, it decreases the required percentage of investments in qualifying portfolio securities from seventy percent to sixty percent, and it permits the acquisition of securities from any person, rather than from issuers and affiliates alone.


"Business development company" means any company which is a business development company as defined in section 2(a)(48) of title I of this Act and which complies with section 55 of title I of this Act, except that —

(A) the 70 per centum of the value of the total assets condition referred to in sections 2(a)(48) and 55 of title I of this Act shall be 60 per centum for purposes of determining compliance therewith;

(B) such company need not be a closed-end company and need not elect to be subject to the provisions of sections 55 through 65 of title I of this Act; and

(C) the securities which may be purchased pursuant to section 55(a) of title I of this Act may be purchased from any person. For purposes of this paragraph, all terms in section 2(a)(48) and 55 of title I of this Act shall have the same meaning set forth in such title as if such company were a registered closed-end investment company, except that the value of the assets of a business development company which is not subject to the provisions of sections 55 through 65 of title I of this Act shall be determined as of the date of the most recent financial statements which it furnished to all holders of its securities and shall be determined no less than annually.

Id.


"Business development company" means any closed-end company which —

(A) is organized under the laws of, and has its principal place of business in, any State or States;

(B) is operated for the purpose of making investments in securities described in sections 55(a)(1) through (3), and makes available significant managerial assistance with respect to the issuers of such securities, provided that a business development company must make available significant managerial assistance only with respect to the companies which are treated by such business development company as satisfying the 70 per centum of the value of its total assets condition of section 55; and

(C) has elected pursuant to section 54(a) to be subject to the provisions of sections 55 through 65.

Id.
Unlike the definition of business development company found in rule 205–3, Congress’s definition does not require the company to be formed and operated “primarily for the purpose of directly acquiring” securities of small and developing companies. Instead, the investment group must maintain a minimum of sixty percent of its total assets in qualifying securities, which need not be purchased directly from the issuer. This less stringent standard, coupled with the statute’s expansive definition of qualifying securities, gives the business development company’s portfolio managers a tremendous increase in flexibility in their selection of investments.

First, the business development company no longer must acquire its securities directly from the issuer. Under rule 205–3, a secondary market purchase of otherwise eligible portfolio company securities would not have been counted toward the “operated primarily” requirement. Congress’s action will have the beneficial effect of allowing business development companies to purchase securities held by the founders and initial investors in small companies, thereby permitting business developers to take over the effective control and management of a small company without requiring the issuance of new securities. Such a result was not possible under rule 205–3 and could have stymied some business development investments.

However, removal of the rule’s requirement of primary market acquisitions may result in the loss of a principal benefit sought by both the SEC and Congress—increased capital formation for

192. See notes 93–114 supra and accompanying text.
193. See notes 191–92 supra for text of statute.
194. See notes 93–94 supra and accompanying text.
195. One commentator on rule 205–3 had observed:

The requirement [of direct acquisitions] would preclude an opportunity to purchase securities from existing investors in an otherwise eligible portfolio company. Thus, a leveraged buyout of a subsidiary or division of a company which seeks or is forced, e.g., by a Federal Trade Commission decree, to get out of a particular business (when management is capable but without sufficient resources to fund the divestiture) would be precluded. The proposed rule would also preclude the purchase of the securities of a family-owned and managed business (e.g., where the principal may want to retire or is deceased), the purchase of securities held by a pension fund investor where continued illiquidity of the company’s securities may require disposition because of ERISA, or the purchase of securities held by founders of a company which cannot or does not want to go public and where continued illiquidity of the founders’ securities acts as a significant impediment to development of the company’s business.

Cooley, Godward letter, supra note 30, at 6–7.
196. See note 28 supra and accompanying text.
small business. Under the statute, it is theoretically possible for performance-based compensation to be paid to the adviser of a business development company which deals solely in the secondary market, and invests no new capital in portfolio companies.\textsuperscript{198} Presumably, Congress believes that managerial assistance alone is a vital need of developing companies.

Second, the business development company is no longer faced with the uncertainty of the "operated primarily" language of rule 205–3.\textsuperscript{199} The statute instead imposes a clear, and quite liberal, quantitative standard for minimum investment in qualifying securities.\textsuperscript{200} The sixty percent floor is far lower than that which the SEC would have permitted under the rule;\textsuperscript{201} in conjunction with the statute's broader definition of "eligible portfolio company," the Act's forty percent "window"\textsuperscript{202} allows the business development company's management tremendous freedom in managing the portfolio.\textsuperscript{203}

This increased freedom suppresses one of the potential hazards of rule 205–3—that the investment adviser might become tempted to continue recommending high risk projects solely with the prospect of continued performance-based compensation.\textsuperscript{204} The rule compensated for this threat by imposing numerous safeguards for investor-advisees; the statute does not directly provide any such protection. It appears, however, that Congress has vitiated the former threat by allowing greater latitude to advisers, and thereby reducing, if not totally removing, the incentive to engage in intentional risk mismatch.

Congress also has removed the rule's requirement that the business development company maintain a minimum holding of five percent of the portfolio company's outstanding voting securi-

\textsuperscript{198} The definition of a business development company contained in the Advisers Act permits the purchase of securities of otherwise eligible portfolio companies from any person. See note 190 supra. So long as the investment group then provides "significant managerial assistance" to the issuer of the securities, the issuer may be counted toward the 60% floor.

\textsuperscript{199} See notes 103–05 supra and accompanying text.

\textsuperscript{200} The 70% and 60% levels represent a compromise between the SEC and the business development industry, but were not based on any empirical evidence. H.R. Rep. No. 1341, 96th Cong., 2d Sess. 38–39 (1980).

\textsuperscript{201} See notes 103–05 supra and accompanying text.

\textsuperscript{202} This term is used by the House Report. H.R. Rep. No. 1341, 96th Cong., 2d Sess. 38 (1980).

\textsuperscript{203} Id. at 39–40.

\textsuperscript{204} See notes 106–14 supra and accompanying text.
Instead, the statute requires the business development company to "[make] available significant managerial assistance" to the issuers of securities that it counts toward its sixty percent floor. The SEC had imposed the five percent holding requirement in order to achieve the same managerial effect, apparently on the grounds that a clear quantitative standard was the better approach. Congress's action, however, will permit collaborative efforts by several business development companies, none of which would have met the SEC's five percent rule on its own. Although interpretation of "significant managerial assistance" will, presumably, impose some burden on the enforcement process, the standard will permit increased cooperation between business development groups and allow developing companies which are too large for the resources of a single business development company to benefit from facilitated capital formation and managerial assistance.

The statute, unlike the rule, imposes no minimum investment requirement on the investors of business development companies. Consequently, it will increase the pool of potential participants in these ventures, and thereby, the potential asset pool available for investment in eligible portfolio companies. However, it also removes a potential, albeit very crude, safeguard against investor risk mismatch.

Through its definition of business development company, Congress has expanded significantly the potential application of business development company performance-based compensation. It is now lawful for a group of business development companies to pay their investment advisers performance-based compensation, even though the companies are made up of inves-

205. See notes 115–20 supra and accompanying text.
206. See text of statutes at notes 190–91 supra.
207. See note 116 supra and accompanying text.
208. See notes 119–20 supra and accompanying text.
209. One commentator on the proposed rule noted:
   Perhaps the most myopic provision in the proposed rule is [the minimum 5% holding]. The 5% test would effectively eliminate many venture capital firms from innumerable, traditional venture capital investments. It would also serve to concentrate economic and voting control of new and developing companies in the hands of fewer investors to the detriment of the management of such enterprises and would make it much more difficult for such entities to raise capital because of an inability to spread the significant risk which such companies' securities represent.
   Cooley, Godward letter, supra note 30, at 7–8.
210. See notes 121–27 supra and accompanying text.
211. See notes 169–77 supra and accompanying text.
tors who have individually placed only small sums at risk, and who maintain only sixty percent of their portfolios in the securities, purchased on the secondary market, of a single eligible portfolio company.212

2. "Eligible Portfolio Company"

Section 2(a)(46) of the Investment Company Act, added by the 1980 amendments,213 was incorporated into the Advisers Act through the definition of a "business development company" in section 202(a)(22).214 The new section defines an "eligible portfolio company" in terms far broader than those contained in rule 205–3.215 Congress’s definition does not require, as did the SEC’s,216 that the portfolio company be "small." Instead, an eligible portfolio company may be any domestic issuer of securities which is not an investment company and which is: (a) controlled


"Eligible portfolio company" means any issuer which —

(A) is organized under the laws of, and has its principal place of business in, any State or States;

(B) is neither an investment company as defined in section 3 (other than a small business investment company which is licensed by the Small Business Administration to operate under the Small Business Investment Act of 1958 and which is a wholly-owned subsidiary of the business development company) nor a company which would be an investment company except for the exclusion from the definition of investment company in section 3(c); and

(C) satisfies one of the following:

(i) it does not have any class of securities with respect to which a member of a national securities exchange, broker, or dealer may extend or maintain credit to or for a customer pursuant to rules or regulations adopted by the Board of Governors of the Federal Reserve System under section 7 of the Securities Exchange Act of 1934;

(ii) it is controlled by a business development company, either alone or as part of a group acting together, and such business development company in fact exercises a controlling influence over the management or policies of such eligible portfolio company and, as a result of such control, has an affiliated person who is a director of such eligible portfolio company; or

(iii) it meets such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of this title.

Id.

214. See note 190 supra.

215. See note 129 supra.

216. See notes 134–39 supra and accompanying text.
by a business development company or group of business development companies acting together; (b) bankrupt or unable to meet its obligations without assistance other than conventional lending arrangement; (c) conforming to such other criteria as the SEC may establish by rule.\textsuperscript{217}

Unlike the rule,\textsuperscript{218} the definition does not preclude all prior public sales of the portfolio company's securities. With one exception, however, all of the qualifying securities must be purchased in nonpublic offerings, unless the SEC rules otherwise.\textsuperscript{219} The exception is for the securities of portfolio companies over which the business development company has both actual and potential control, and on whose board the business development company has an affiliated person serving as director.\textsuperscript{220} Likewise, the statute abandons the rule's limitation of the size of the portfolio company, and the result is further expansion of investment discretion for the managers of the business development company's portfolio; even the largest corporation can obtain the benefit of investments by business development companies which pay their investment advisers performance-based compensation.\textsuperscript{221}

The definition of eligible portfolio company so as to include issuers which either are undergoing bankruptcy proceedings or are unable to meet their current obligations without special assistance is a significant change from rule 205–3. A large, publicly held corporation—which under the rule could never have become an eligible portfolio company\textsuperscript{222}—can now become a qualifying issuer of securities if it is in economic hard straits.\textsuperscript{223} Congress thus en-

\textsuperscript{217. Id.}
\textsuperscript{218. See notes 140–43 supra and accompanying text.}
\textsuperscript{220. Id.}
\textsuperscript{221. For example, Investment group G, made up of business development companies A, B, and C, controls eligible portfolio company T. T is a nonpublicly held company. T goes public. B purchases additional shares in the market, either primary or secondary. 60% of B's portfolio is made up of T's securities. The remainder of B's portfolio is made up of non-eligible securities. T's size is irrelevant, and B is still able to pay its investment adviser performance-based compensation.}
\textsuperscript{222. See note 134 supra.}
courages the influx of capital not only to small and developing companies, but also to companies in need of rehabilitation.\textsuperscript{224}

Though a deviation from the rule’s policy, this congressional expansion of coverage is a logical extension of the performance-based compensation concept. Companies which are insolvent are normally unable either to borrow funds from conventional financial intermediaries or to raise substantial capital in the general securities market. These qualities are identical to those of small and developing companies, and result from the same basic problem: a high level of uncertainty about their future performance.\textsuperscript{225} Insolvent companies, like small and developing companies, are high risk projects, and business development companies, along with their investment advisers, specialize in such high risk projects.\textsuperscript{226} The ability to select likely targets for successful rehabilitation is a talent similar to that employed in the selection of small and developing firms; likewise, the extra managerial efforts in business development are equally useful to developing or rehabilitating companies. Thus, extension of performance-based compensation to the investment advisers of those business development companies which purchase securities of insolvent or reorganizing firms serves the same policies which support the payment of performance-based compensation when small and developing companies are benefited.

This expansion of eligibility, however, may create a loophole in the statutory scheme. The statute, like the rule, excludes investment companies from eligibility,\textsuperscript{227} but it is possible to interpret the statute, as enacted, so as to allow eligibility to an insolvent investment company.\textsuperscript{228} If this interpretation were applied, it

\textsuperscript{224} H.R. REP. No. 1341, 96th Cong., 2d Sess. 42 (1980).
\textsuperscript{225} See notes 40–51 supra and accompanying text.
\textsuperscript{226} See notes 40–42 supra and accompanying text.
\textsuperscript{227} See note 213 supra.
\textsuperscript{228} Section 55(a)(3) of the Investment Company Act provides:

\textnormal{(a) It shall be unlawful for a business development company to acquire any assets (other than those described in paragraphs (1) through (7) of this subsection) unless, at the time the acquisition is made, assets described in paragraphs (1) through (6) below represent at least 70 per centum of the value of its total assets (other than assets described in paragraph (7) below):

(3) Securities purchased in transactions not involving any public offering from an issuer described in sections 2(a)(46)(A) and (B) [see text of section at note 213 supra] or from a person who is, or who within the preceding thirteen months has been, an affiliated person of such issuer, or from any person in transactions incident thereto, if such securities were —

(A) issued by an issuer that is, or was immediately prior to the purchases of its securities by the business development company, in bankruptcy proceedings, subject to reorganization under the jurisdiction of a court of competent jurisdiction,
would be possible for a business development company to purchase the securities of an investment company—albeit a rehabilitating one—and still qualify its own investment adviser for performance-based compensation. This presents a potential for abuse.\footnote{229}

Nevertheless, if this loophole exists, it may be tolerable. The insolvency of an investment company may discourage further private capital investment of this type, which could result in a reduction in capital formation. The statute’s “loophole”, which could allow a business development company to “rescue” a failing investment company, may counteract this negative effect.

**B. Protection of Investors**

Rule 205-3 provided numerous safeguards to investor-advisees against both investment mismatch by the individual investor and abuse of power by the investment adviser who receives performance-based compensation.\footnote{230} The SEC was compelled by section 206A to make certain that it was not reducing the level of protection previously offered to investor-advisees.\footnote{231} Although Congress was not bound by the same standard, it stated that it “intended to preserve to the fullest possible extent these types of

or subject to a plan or arrangement resulting from such bankruptcy proceedings or reorganization;

(B) issued by an issuer pursuant to or in consummation of such a plan or arrangement; or

(C) issued by an issuer that, immediately prior to the purchase of such issuer’s securities by the business development company, was not in bankruptcy proceedings but was unable to meet its obligations as they came due without material assistance other than conventional lending or financing arrangement.

Pub. L. No. 96-477, 94 Stat. 2479 (1980) (emphasis added). The definition of business development company for purposes of the Advisers Act modifies this section in two ways: (1) by lowering the 70% floor to 60%; and (2) by permitting the purchase of securities from any person. \textit{See} note 190 \textit{supra}.

It is possible to interpret subsection (C) of the business development company definition — “the securities which may be purchased pursuant to section 55(a) of title I of this Act may be purchased from any person” — to mean that “from any person” is to be substituted for the emphasized portion of § 55(a)(3). If this is the case, there would no longer be a direct link between § 55(a)(3) and § 2(a)(46)(B), which is the prohibition against investment companies becoming eligible portfolio companies.

An argument can be made that “from any person” must instead be read to be in addition to the emphasized words, and modified by their effect. In this case, the link to § 2(a)(46)(B) would remain, and insolvent investment companies would be ineligible for business development company investment, at least for performance-based compensation purposes.

\footnote{229} See notes 144–45 \textit{supra} and accompanying text.

\footnote{230} See notes 153–58 \textit{supra} and accompanying text.

\footnote{231} See note 152 \textit{supra} and accompanying text.
The 1980 amendments, however, may result in a significant weakening of investor safeguards, a weakening that could have been avoided while still obtaining the desired benefits.

Congress has abandoned the rule's requirements for investor knowledgeability, investor access to material information, minimum investment by investors, and minimum investment by the investment adviser. Yet, each of these had, under the rule, contributed substantially to investor protections against both abuse of power by the investment adviser and individual investment mismatch. Congress's failure to provide for knowledgeability and access to material information requirements are the most significant weaknesses of the 1980 amendments. As noted, performance-based compensation is permitted for investment advisers to business development companies in order to attract more such advisers. The increased participation of such advisers is expected to lead to increased capital formation for high risk enterprises such as small, developing, and insolvent companies. In turn, this should lead to an increase in the numbers of investors engaging in high risk investments. Yet, unlike the rule, the statute provides no explicit protection for unwary investor-advises for whom such high risk undertakings are inappropriate. Furthermore, the statute does not contain the rule's protections against an adviser engaging in intentional risk mismatches in order to continue the payments of performance-based compensation.

Rule 205-3 required that the investor-advisee possess a minimum level of financial and investment "sophistication": both the ability to formulate insightful questions concerning the risk and valuation of the investment package, the business development company, and the investment adviser, and the ability to compel full and complete answers to these questions. Congress has recognized the worth of requiring sophisticated investors in circum-

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233. See notes 159–63 supra and accompanying text.
234. See notes 164–68 supra and accompanying text.
235. See notes 169–77 supra and accompanying text.
236. See notes 178–82 supra and accompanying text.
237. See notes 24–27 supra and accompanying text.
238. See note 28 supra and accompanying text.
239. See, e.g., note 179 supra and accompanying text. Congress's broad definition of business development company may, however, vitiate this threat. See notes 204–05 supra and accompanying text.
240. R. COFFEY, SECURITIES REGULATION 414a (1978) (unpublished text in Case Western Reserve University Law School Library); see note 159 supra and accompanying text.
stances where the risk of investment is an unknown quantity.\textsuperscript{241} It seems anomalous, however, to require a high degree of sophistication in circumstances where the risk factor may be either low or high but not to require such sophistication where it is absolutely certain that the risk factor will be high. The opportunity for large-scale mismatching of investors with risk, avoided under rule 205-3, appears quite probable under the statute.\textsuperscript{242}

This result need not have been reached by Congress. Certainly, requiring the business development company to limit its investor group to sophisticated persons alone would severely limit the initial pool of eligible investors. However, by following the scheme of rule 205-3, which allowed investment by any persons acting under the guidance of sophisticated advisers,\textsuperscript{243} the amount of capital available would have been significantly increased, while the problems of risk mismatch would still be avoided.

Similarly, the failure of Congress to require the investor to have access to material information seriously weakens the ability of investors to protect themselves; changes in the portfolio's "mix" of securities could also alter the risk and return factors upon which the original investment decisions were made. Yet without access to the material information about this "mix", the investor would be unaware of the risk and return alternatives, and would continue the investment. The resulting risk preference mismatching could lead to decline in the numbers of investors willing to engage in business development activities.\textsuperscript{244} Clearly, this re-

\textsuperscript{241} The Small Business Investment Incentive Act of 1980 was passed with an amendment containing the Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, 94 Stat. 2294 (1980). The latter contains an amendment to the Securities Act of 1933 defining the term "accredited investor" to include any person "who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." This represents a codification of Rule 242, 45 Fed. Reg. 6367 (1980) (to be codified in 17 C.F.R. § 230.242).

\textsuperscript{242} A hypothetical business development company could be made up of investors on fixed incomes, who invest their life savings (perhaps leveraged) in the business development company after being persuaded to do so by the investment adviser (albeit without fraud on the latter's part). The investment adviser would counsel acquisition of a portfolio which would qualify him or her for performance-based compensation, in hopes of sufficient success in the overall investment to yield the adviser a large fee. Yet the inherent high risk (high variance of returns) could result in a total loss.

This example represents a case of total risk mismatch. The investors should be risk averse, and investing in securities with lower variance as to return.

\textsuperscript{243} See rule 205-3(b)(4)(ii), supra note 20, at 44,113-3.

\textsuperscript{244} This observation makes the behavioral assumption that investors who lose their investment once will be wary of returning to the same type of transaction for fear of losing twice. It also assumes that eventual public exposure of the high risk factor combined with
sult could be avoided by requiring disclosure of material information, but Congress has declined to do so.

C. The Amount of Allowable Compensation

Congress has amended section 205 of the Advisers Act to permit the payment of performance-based compensation to investment advisers who serve business development companies. The level of compensation allowed is limited to twenty percent of the realized gains of the business development company over a period not to exceed one year, and must be calculated net of both realized capital losses and unrealized capital depreciation. The twenty percent level of compensation is more restrictive than the compensation allowed under rule 205-3, which had no ceiling. The rule also permitted the inclusion of unrealized capital gains, which is not allowed by the statute.

V. Conclusion

This Note has examined the modification of section 205 of the Investment Advisers Act of 1940 to permit the payment of performance-based compensation to investment advisers working for business development companies—in light of the dual objectives of increasing the flow of capital to small, developing, and insolvent companies while maintaining adequate safeguards for the investor. The SEC and Congress have determined that increased capital formation for small businesses can be facilitated by a grant of exemption from the prohibition contained in section 205 against performance-based compensation to investment advisers of business development companies, since these companies are concerned primarily with the active investment in and management of high risk companies unable to finance their activities through conventional financial intermediaries. It is believed that the exemption from section 205 will facilitate the efforts of

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246. See notes 183-87 supra and accompanying text.
247. See notes 1-32 supra and accompanying text.
248. See notes 24-32 supra and accompanying text.
249. See notes 21-22 and 40-52 supra and accompanying text.
these companies, and thereby increase the quality and quantity of investment in small companies.

The SEC limited the application of rule 205-3 to business development companies likely to satisfy the needs for additional capital resources of small businesses by means of requirements concerning the size of the eligible portfolio company, the non-public nature of the portfolio securities, the necessity of direct acquisition of the securities and the necessity for the business development company's continued status of holder of small and developing company securities. In contrast, Congress has expanded the category of eligible portfolio securities to include insolvent firms and large companies.

The SEC sought to protect the investors in the business development companies with the requirement of investor knowledgeability, investor access to material information, minimum investment requirements for both investor and adviser, and performance-based compensation calculations using a netting process of all losses as well as any gains. Congress has omitted all of these protective devices except the last; it modified the netting process to be exclusive of unrealized gains.

Rule 205-3 as written served the essential purposes of the Advisers Act while giving assistance to the small businesses which form a crucial sector of the American economy. Several modifications would have strengthened the proposed regulation. First, the SEC should have adopted its alternate definition of portfolio company size to increase the certainty that investments would flow only to the small and developing companies it targeted for assistance. Second, for added investor protection, a positive burden of disclosure of material information should have been imposed upon the investment adviser, and the burden of inquiry placed on the investor under the proposed rule should have been rejected.

250. See notes 134–39 supra and accompanying text.
251. See notes 140–43 supra and accompanying text.
252. See notes 93–105 supra and accompanying text.
253. See notes 103–05 supra and accompanying text.
254. See notes 221–28 supra and accompanying text.
255. See notes 159–63 supra and accompanying text.
256. See notes 164–68 supra and accompanying text.
257. See notes 169–82 supra and accompanying text.
258. See notes 183–87 supra and accompanying text.
259. See notes 232–43 supra and accompanying text.
260. See notes 244–45 supra and accompanying text.
261. See notes 138–39 supra and accompanying text.
262. See notes 168–69 supra and accompanying text.
Third, in addition to the rule's requirement of a minimum investment by all investors, all investors in business development companies should have been required to be capable of bearing the economic risk of their investment.263 These modifications would have increased the proposed rule's protection of investors and the certainty of investment by business development companies in small and developing companies.

Congress's amendments to the Advisers Act contained in the Small Business Investment Incentive Act of 1980 fail to provide the protection needed by investors in the high risk investments represented by business development companies.264 Such protection was offered by the SEC in its proposed rule, and it could be added to the statutory language without significantly reducing the benefits of additional capital formation for small, developing, and insolvent companies. Such modification would return the protections previously existing under the Investment Advisers Act of 1940.

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263. See notes 172–77 supra and accompanying text.
264. See notes 232–43 supra and accompanying text.