Hearing on "Examining the Small Business Investment Company Program"

House Small Business Committee

Subcommittee on Investigations, Oversight and Regulations

July 25, 2013

Testimony by Steven Brown, Trinity Capital Fund II, LP, Phoenix, Arizona

On behalf of the Small Business Investor Alliance

www.SBIA.org

Good morning Chairman Schweikert, Ranking Member Clarke, and Members of the House Small Business Subcommittee on Investigations, Oversight, and Regulations.

Thank you for holding this oversight hearing today to examine the Small Business Investment Company (SBIC) program. I am here today on behalf of the Small Business Investor Alliance, the premier organization of lower middle market private equity funds and investors.

My name is Steven Brown and I am the Managing Member of the General Partner of Trinity Capital Fund II, LP, based out of Phoenix, Arizona. Trinity Capital became a licensed SBIC in September of 2012, with a current investment capacity of $76 million, assuming two tier SBA leverage. Trinity focuses on equipment and fixed asset leasing and financing to both earlier staged and emerging growth small businesses primarily backed by Venture Capital and/or other institutional investment. The industries we fund most are telecommunications, manufacturing and technology, with our primary market focused in the southwest and west, however we will fund deals in other US markets.

Since our fund was only recently licensed, I can only speak to our direct experiences during the relatively brief period we have been in the program. However, because this hearing is performing oversight of the entire SBIC program, I am attaching a letter from our trade association that highlights the broader perspective they have seen across the industry over a longer period of time.

Background

What was true in1958 is still true today. It is very inefficient and difficult for large financial institutions to provide capital to small businesses, even if the small business is profitable and trying to grow. To address this reality Congress and the Eisenhower Administration applied market principals as they created the SBIC credit facility that uses leverage to augment private investment in the small business market. Because of the way the program is structured, this leverage must be provided with a zero subsidy rate – meaning no cost to the taxpayer. The SBIC debenture program continues to successfully operate at its statutorily required zero subsidy rate. The SBIC debenture program has consistently run at a surplus of several hundred million dollars and the President’s budget estimates that this surplus will grow next year. Since the creation of the SBIC program, SBICs have invested more than $58 billion in over 100,000 domestic small businesses. Some of these small businesses have since grown into icons of American free enterprise including: Apple, Intel, Outback Steakhouse, Callaway Golf, and many others. There are also thousands of other fantastic SBIC-backed businesses that are lesser known, but that are mainstays of local economies.

SBICs are highly regulated private equity funds that invest exclusively in domestic small businesses. Debenture SBICs raise private capital, pass a rigorous licensing process, and then are able to increase the amount of capital available for investment by accessing leverage through an SBA-backed credit facility. These funds then invest in a portfolio of U.S. small businesses, creating jobs, fostering innovation, and fueling economic growth.

The SBIC debenture program fills a critical need by providing growth and transition capital to small businesses. During the financial crisis SBICs scaled up to provide critical capital that saved many businesses and many jobs. The SBIC debenture program continued to operate at a zero subsidy rate throughout the financial crisis. Private capital of operating SBICs doubled over the past four years, growing from $3.4 billion at the end of fiscal year 2009 to $6.8 billion today. This growth came at no additional cost to the taxpayer, a remarkable feat for a public-private partnership. This program is good public policy because it fills a critical market need that otherwise would largely go unmet while simultaneously providing real taxpayer protections. This is a rare alignment of market forces with thoughtful public policy.

Trinity Capital is an example of how an SBIC Fund can provide critical capital to businesses that will now continue to grow long after the SBIC has exited the investment. Trinity Capital to date has funded equipment purchases for the growth of a manufacturing line with Suniva, a manufacturer of solar cells based in Atlanta, Georgia. Suniva has experienced strong revenue, has survived the solar manufacturing down market and is a strong US based manufacturer supplying the residential supply market. Our capital has helped grow capacity at the Suniva plant. We have also funded manufacturing equipment for Soraa, a US based manufacturer of LED lighting, an emerging technology that is replacing much of the existing lighting in the marketplace with more efficient and cost effective energy lighting. Soraa is experiencing growing revenues and has state of the art technology in this space. We have also funded Clariphy, a California based manufacturer of chips for fiber optic communications. Clariphy's product produces a much more efficient use of fiber optic networks resulting in more bandwidth and speed. Trinity financed test equipment for Clariphy, a company who is experiencing strong and growing revenue. We are currently funding a tire recycling company that takes tire manufacturing waste and grinds it into a product that is used for production back into the tire industry. Trinity is currently funding and plans to fund innovative US based companies that are providing both technology and know how to make existing processes more efficient and more profitable. Additionally we have already demonstrated a desire and ability to work with companies that are coming up with better and more efficient energy solutions and alternatives.

Let me start out by highlighting how Congress can act right away to increase capital flowing to small businesses. Congressman Steve Chabot (OH-1) introduced the SBIC Modernization Act (H.R. 1106) earlier this year which increases a critical cap on the amount that successful SBICs can access through the SBA credit facility.

In fact, thanks to the bipartisan work by this committee at the end of last year, the same legislation passed through the House of Representatives on December 17, 2012, with a very strong bipartisan vote of 359-36; however given the time constraints at the end of the year, the Senate did not act on the bill. Congressman Chabot reintroduced the bill this year with bipartisan support from nine of his colleagues. It is worth noting that a Senate version of the bill, backed by Senators Landrieu (D-LA) and Risch (R-ID), passed out of the Senate Committee with broad bipartisan support.

It is important to note that H.R. 1106 does not increase federal spending or require new appropriations. H.R. 1106 adjusts the maximum amount of leverage available to multiple SBICs to a limit of $350 million. The only funds that can access the higher limits are funds that have successfully operated an SBIC and have gone through the licensing process at least twice. Increasing this limit will keep proven small business investors in the program and increase the amount of capital flowing to small businesses. It is a logical to keep the best small business investors investing domestically. This increase has bipartisan, bicameral, and Adminstration support. We encourage its passage.

Now let me turn the focus of my testimony to discuss issues that should be relevant as part of an oversight hearing. It is important to put on the record the very significant improvements to the SBIC program that have been implemented over the past several years. Licensing times have been reduced from a waiting period of nearly two years to about six months. The number of licenses issued per year has increased from fewer than 10 per year to 30 per year. This increase in licensing was achieved while maintaining, if not raising, the standards for licensure. Thanks to legislative improvements, the number of regulatory hurdles to normal fund operations has been reduced and has allowed SBA resources to be better allocated to address more pressing needs. These improvements are important and should not be overlooked.

These reforms attracted more private sector investment and allowed SBICs to operate closer to the speed of business to back thousands of successful entrepreneurs. Despite the many improvements, there are still areas that require meaningful changes to maximize the program’s ability to get capital in the hands of small businesses.

SBA Leadership

The biggest short term challenge that must be addressed is the departure of many key personnel at the SBA. The SBIC program has benefitted greatly by the quality of the people appointed to lead the SBA and the attention they paid to the SBIC program. SBA Administrator Karen Mills is expected to leave her post by the end of August and there is no word yet on who her replacement will be. There are also vacancies for the positions of the Deputy Administrator, the Associate Administrator for SBA’s Office of Investment, which administers the SBIC program. These are all important positions at SBA that should be filled as soon as possible. The Senate confirmation process takes a long time, and without any new appointments by the President, this process will be ongoing through the fall. We do not want to see programs in charge of regulating and overseeing billions of dollars lacking strong leadership. There are significant questions about how licensing and certain operational decisions will be made when there is no Administrator. It is not clear who will be acting as Administrator when this position is vacated in August.

Technology

There are a number of major technological and information systems challenges that make it very difficult for SBA staff to administer the SBIC program effectively. We encourage a meaningful review and improvement in both the technological tools and the policies around them.

One of the major problems for SBIC funds is the inability of the SBA to accept documents electronically. The SBA still requires SBICs to send hard copies for most documentation requests. The email system at SBA is unable to send or receive many documents. It is common that critical documents are delayed or lost in the mail room. The SBA needs to be able to communicate electronically. Further, it has been over a decade since laws were changed to require the acceptance of digital signatures, but the SBA requires paper copies, often with multiple copies. The SBA needs to modernize its documentation collection process to allow SBICs to communicate and submit documents electronically.

SBA has attempted to update some of their data collections into an electronic format. The SBICs applaud them for their efforts, but the execution can be improved. The new Form 468 electronic system was delayed in coming on line and has been taken down to fix bugs. Once the system is complete and functional, it will provide great efficiency to SBA and to SBIC funds, but we are not there yet.

SBA staff have important regulatory duties and need the tools to perform those duties well. We would encourage the Committee to review the technical capabilities of the SBA and consider outsourcing operations or services that require technologies that SBA is not able to provide their employees themselves.

Licensing Process

The process of applying for a license and becoming a licensed SBIC varies from fund to fund. In our experience, the process took longer than we expected, but we had a change of personnel along the way so we understood and it was successful in the end. The SBA could be more transparent with applicants after the submission of the Management Assessment Questionnaire (MAQ). The time frame between the MAQ and licensing could be reduced if the SBA establishes a consistent work flow process that is transparent to the fund applying for a license. This workflow process could be improved by allowing information sharing and establishing consistent communication between the SBA and the fund. It would also benefit the fund if there was a structure in place to see the estimated time remaining to become licensed.

Dodd-Frank

The last section of my testimony focuses on the threat of double regulation (in three potential situations) as a result of the Dodd-Frank Act. While the statute provides a limited exemption from SEC registration for SBICs that "solely" advises one or more licensed Small Business Investment Company, clarification is needed to prevent cases of double regulation.

The first issue involves "SBIC capital" counting towards the $150 million threshold. If an adviser advises SBICs and any other private funds (and the total assets under management exceed the $150 million registration threshold), then the threshold for full registration is triggered. The SEC has taken the position that registration is triggered if an adviser to an SBIC has absolutely any capital in any non-SBIC, no matter how small. Therefore, many SBIC advisers are forced to register with the SEC in spite of the SBIC exemption.

A second issue deals with fund managers that manage a licensed SBIC and a non-related Venture Capital fund. Both SBICs and Venture Capital Funds are excluded from SEC registration, but only if the manager "solely" manages these funds, and not another non-related fund. The SEC has taken the position that a manager of a Venture Capital Fund and an SBIC fund must register with the SEC if their assets under management exceeds $150 million. On their own they are exempt, but jointly they are captured in the regulatory regime.

The third issue involves the regulation of SBICs by the states. There is no explicit language in the Dodd-Frank Act that excludes SBICs from state registration. Therefore, federally licensed and regulated SBIC funds must register with multiple states and territories. A technical correction is needed to remove this unintended double regulation, leaving SBICs fully regulated by their licensing and reporting entity, the SBA. SBICs would continue to be closely regulated by the SBA, as they have for 55 years.

In closing I want to reiterate the success, the strength and my support of the SBIC program. The Agency is licensing qualified candidates through a stringent and thorough due diligence process which creates a high standard for licensees to meet before become licensed and having access to SBA leverage and thus becoming a valuable funding source to Small Business concerns and the economy at large. On behalf of all SBIC's we applaud the efforts of the agency and its employees, while encouraging continued improvements and efficiencies as referenced herein that can streamline the process of licensing and the communication with its candidates and licensees, without lowering the important and high standard that had been set by the Agency to award an SBIC License.

Thank you for giving me the chance to share both my experience and the perspective of the SBIC industry. Please see the accompanying letter below from SBIA President Brett Palmer.

Steven Brown, President TCI and Managing General Partner Trinity Capital Fund II (TCF)

Biography - Steve Brown brings 28 years of lending, investment and leasing experience to TCF. Prior to starting TCF, he was a General Partner with Point Financial Capital Partners, which managed a Venture Leasing Fund and he led both originations and lease financing efforts for all early stage lease finance at Point. Prior to Point he served as the President and CFO of InvestLinc Financial Services, which was an early-stage Private Equity Fund Manager and Business Consulting Firm. Prior to InvestLinc, he was a partner in Cornerstone Equity Partners, a private equity fund manager, and was co-founder/manager of

Cornerstone Fund I, a private equity fund based in Phoenix, Arizona. In addition, Steve has worked with private investment companies and banking institutions in both real estate and commercial lending and investment roles. He has served on the board of directors of numerous operating companies. Mr. Brown holds a B.S. degree from McNeese State University in Business Administration and Marketing.

SMALL BUSINESS INVESTOR ALLIANCE

July 25, 2013

Rep. David Schweikert, Chairman
Subcommittee on Investigations,
Oversight and Regulations
House Small Business Committee
2361 Rayburn House Office Building
Washington, DC 20515

Rep Yvette Clarke, Ranking Member
Subcommittee on Investigations,
Oversight and Regulations
House Small Business Committee
2361 Rayburn House Office Bldg.
Washington, DC 20515

Dear Chairman Schweikert and Ranking Member Clarke,

Thank you for holding this hearing on the Small Business Investment Company (SBIC) debenture program. The purpose of this letter is to provide a brief overview of the state of the SBIC program to augment the testimony of Steven Brown.

The SBIA is the trade association representing lower middle market private equity funds, the funds investing in domestic small businesses. We count nearly all actively investing SBIC funds as members. The SBIA promotes a healthy and competitive lower middle market for small business investing. We support the SBIC program because it fills a critical market need in a way that aligns market forces with good public policy. If not for the SBIC program, thousands of good businesses would not be able to access growth capital.

The SBIC program has grown and improved dramatically over the past several years. Real improvements have been implemented by SBA and great credit is owed to the team that has managed this change. Processes are often faster and there is a greater diversity in fund managers. There are more licensed SBIC debenture funds than ever before and, because of the SBA's high licensing standards, they have been excellent stewards of the taxpayers' trust. These successes and improvements are profound and noteworthy. Our suggestions for improvements should not detract from the major accomplishments that have already been implemented. These suggestions are offered in hopes that SBA can use them to build upon their successes.

Standard Operating Procedures

The Standard Operating Procedures (SOP) that guide the operations of the program are overdue for modernization. The SOP does not reflect the real policies and procedures that are in place. Both the SBA and the SBICs would benefit from a SOP that reflects the reality of what the SBA is doing and is going to do. We would also suggest that the SBA put out any proposed changes for comment so that changes made are fully considered for maximum effectiveness.

Technology

SBA's Office of the Chief Information Officer has not adequately supported the Investment Division with the tools needed to efficiently perform their duties. The technology resources for the SBA are woefully inadequate and hinder the ability of the SBA to operate effectively.

The email system is so limited that emails with documents attached often cannot get through to SBA staff. This limitation forces documents to be mailed in, often in duplicate, and the mail room at the SBA can often be a black hole or at least a time machine – documents disappear or reappear weeks after being mailed in. Many applicants now have their documents hand delivered to the SBA. The private sector uses data rooms and other basic technology to manage information. SBA would benefit, both from cost savings and time savings, from using basic, readily available information sharing and workflow technologies.

One of the most promising improvements to SBA's technology has also been one of the more frustrating. SBA is moving to a web based data collection system for the Form 468. Once operational this will significantly save time and resources for both SBICs and for the SBA. However, the rollout of the new system has had serious problems. We have lost count on how many false starts and moved deadlines that have surrounded the implementation of the new system. The goal is laudible, but the execution has been disruptive and time consuming. The Investment Division has struggled to get the basic computer resources to execute the new system. Once the system works it will be a major improvement, but we are not there yet. We would encourage the SBA Chief Information Office to better support this and other improvements being made by the Investment Division.

It has been over a decade since laws were changed to require the acceptance of digital signatures, but the SBA requires paper copies and physical signatures, often with multiple copies. The SBA should modernize its documentation collection process and policies to allow SBICs to communicate and submit documents electronically with digital signatures.

Licensing

The process of licensing new and returning SBICs is instrumental to getting capital into the hands of small businesses. It is also one of the most critical taxpayer protections. The licensing process has seen major improvements that are now bearing fruit. This may be the biggest area of improvement at the SBA over the past several years. Licensing is faster and there is a greater diversity among fund managers. Licensing times, particularly for repeat licensees, have dramatically reduced. It should be noted that the Agency Committee has made their meetings a much more regular occurrence which has been one of the reasons that licensing has successfully reduced processing times.

Even with the current licensing improvements, this process deserves review and further improvement. In addition to the technology improvements previously mentioned, the licensing process should have more transparency and fairness to applicants. Some of the general problems that are brought to the attention to the SBIA include: duplication of processes; unwritten rules or non-public standards and processes; lack of consistency; and lack of clarity on standards. All of these concerns have seen improvement over the past several years. However, many, if not most, of these continuing issues are caused by the structure of the Agency Committee.

The core structural problem with the Agency Committee is that is largely composed of SBA senior staff whose primary daily duties are and expertise may not be directly applicable to private equity. They are accomplished and smart professionals, but that does not mean their particular expertise adds value to this particular fund vetting process or protections to the taxpayer. SBIA supports strong fiduciary standards and a rigorous vetting processes, but the Agency Committee is not structured to provide the best of either. The Agency Committee should be restructured or replaced with experts specialized in vetting private equity funds.

The licensing process has many stages with the deepest, most detailed reviews by staff who are specialized in vetting private equity coming in the first several stages. They are quite good at their jobs, even if overworked and under resourced. Despite the efforts of the licensing teams and multiple licensing committees, there are uncommon occasions where funds are rejected at the Agency Committee. These rejections are sometimes based on issues that were never raised previously in the process by the SBA and where the applicant is not given a chance to address the issue. It is unfair to blindside an applicant team that has spent hundreds of thousands of dollars and years of their lives working through the process. If new, negative evidence arises at the 11^{th} hour, then raising it at the Agency Committee would be appropriate. But what we have occasionally seen are rejections based on new interpretations of disclosures that were openly submitted and accepted previously with an affirmative vote from both the Investment and Divisional Licensing Committees. Sometimes the issues raised at Agency, that may effectively terminate the application, are completely new to the applicant or are based on issues not in the record. The Agency Committee should be structured to have clear standards that are consistent throughout the entire process and communicated to the licensing teams and committees. Applicants should be given a fair chance to address any and all issues raised at any stage of the application process.

Further, the SBIA believes that it is inappropriate that the General Counsel gets two votes on the Agency Committee – effectively a veto. It is important to note that by the time the Agency Committee meets to act on an SBIC applicant the legal documents have already been reviewed and approved by the SBA lawyers and the applicants have passed an intensive vetting on the particulars of the applicant fund. Is it ever reasonable to expect that a deputy counsel would vote against his or her boss, the General Counsel, in a committee vote? No. This bloc voting structure is not justified, particularly by lawyers on issues they have already reviewed and approved. If the General Counsel is on the Agency Committee then she or he should have only one vote, just like the rest of the Committee members.

It is worth noting that the Agency Committee structure does not appear to encourage decisions based exclusively on facts in the record, to provide clear guidance for their rejections, or provide for any type of appellate process. Some rejected funds can recover and get an additional review from the Committee, but for some applicants it is a surprise end of the line. If not for the fact that there is such a professional stigma to being rejected for a license, the SBA would be sued for denial of due process and would be forced to fix their due process deficiencies.

The SBIC program is an excellent program that should be viewed as an example of good public policy. We appreciate the hard work and professionalism of the SBA, from the most senior appointments to the most junior staff. Because of their commitment this program works to benefit thousands of small businesses and tens of thousands of employees.

Thank you for your focus on the SBIC program.

Sincerely,

Brett Palmer

Brett Palmer
President