

Congress of the United States  
U.S. House of Representatives  
Committee on Small Business  
2361 Rayburn House Office Building  
Washington, DC 20515-6315

To: Members, Subcommittee on Investigation, Oversight and Regulations  
From: Committee Staff  
Date: July 22, 2013  
Re: Hearing: "Examining the Small Business Investment Company Program"

---

On Thursday, July 25, 2013 at 10:00 a.m., the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the Small Business Administration's (SBA) Small Business Investment Company (SBIC) program. As part of its oversight efforts, the Subcommittee will review whether the SBIC program is meeting the capital needs of small business owners and entrepreneurs while reducing risk to taxpayers.

## I. Introduction

The SBIC program is a public-private partnership created by Congress in 1958 to supplement and boost the availability of private equity capital available to small businesses.<sup>1</sup> The SBA operates the program through the issuance of licenses to privately managed investment funds denominated as SBICs. Once licensed, investment funds can combine capital issued through SBA with private capital to form a pool for making both debt and equity investments in small businesses.<sup>2</sup> All investment decisions are made by the individual SBIC.

SBICs have provided financing to some of the nation's most well-known companies, including Costco, Apple, Intel, Staples and FedEx.<sup>3</sup> In Fiscal Year 2012, debenture SBICs<sup>4</sup> provided nearly \$3 billion to 795 small businesses, and in Fiscal Year 2011, made \$2.6 billion in investments in just over 1,000 small businesses.<sup>5</sup> Since 1958, the SBIC program has provided \$60 billion to more than 109,000 small businesses.<sup>6</sup>

---

<sup>1</sup> The SBIC program was created with the passage of the Small Business Investment Act of 1958, Pub. L. No. 85-669, Tit. III, 72 Stat. 691-95 (codified as amended at 15 U.S.C. §§ 681-687m). Congress determined that a program was needed to stimulate the flow of private equity capital to small businesses. *Id.* at Tit. I, § 102, 72 Stat. 689 (codified at 15 U.S.C. § 661).

<sup>2</sup> See section III, *infra*.

<sup>3</sup> <http://www.sba.gov/content/sbic-program-overview-0>.

<sup>4</sup> For an explanation of a debenture SBIC, See section III, *infra*.

<sup>5</sup> UNITED STATES SMALL BUSINESS ADMINISTRATION, THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM, ANNUAL REPORT FY2012, at 5, available at <http://www.sba.gov/sites/default/files/files/SBIC%20Program%20FY%202012%20Annual%20Report.pdf>.

<sup>6</sup> <http://www.sba.gov/about-sba-services/7367/28791>.

## II. Licensing Process

As already noted, SBA governs the process of licensing investment funds as SBICs. The process differs for those funds seeking a license for the first time, and those seeking a second or additional SBIC license. Investment funds seeking either a first license or a license for an additional fund must go through a two-part process.<sup>7</sup>

For first time applicants, the first phase consists of the applicant completing SBA's Management Assessment Questionnaire (MAQ).<sup>8</sup> The MAQ seeks information involving the applicant's investment plan and business model as well as the years of investment experience of its principals.<sup>9</sup> Next, the MAQ is reviewed by SBA's Investment Committee (IC) which determines if the fund's principals are initially qualified based on experience and track record. If so, the principals are invited to meet with members of the IC, and after this meeting, the IC can either deny the application or issue a "green light" letter which signifies that the applicant is authorized to raise money and file a formal application. The "green light" letter is normally issued three to four months after the submission of the MAQ.<sup>10</sup> The MAQ process is not required by statute, mentioned in SBA regulations, or set out in interpretive rules (called standard operating procedures<sup>11</sup>) adopted by the agency.

After receiving a "green light" letter, the fund is responsible for raising a minimum amount of capital (currently \$5 million) from private investors.<sup>12</sup> After raising capital, the investment fund applicant can file a formal application. The formal licensing process consists of SBA reviewing additional information about the applicant and its management team<sup>13</sup> as the agency determines if there is a qualified management team and if the SBIC has a good chance of operating profitably.<sup>14</sup> This step in the application process generally takes six months.<sup>15</sup> Before receiving final licensure, all principal members of the investment fund's management team must attend a one day regulations class held by SBA.<sup>16</sup>

SBICs seeking an additional license go through a very similar process as is described in the preceding paragraphs. The first step consists of SBA analyzing the existing or prior fund and making a recommendation to the IC on whether or not to issue a "green light" letter inviting the applicant to

---

<sup>7</sup> MICHAEL B. STAEBLER, PEPPER HAMILTON, AN OVERVIEW OF THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM 15 (2011), available at [http://www.pepperlaw.com/pdfs/SBIC\\_Staebler0111.pdf](http://www.pepperlaw.com/pdfs/SBIC_Staebler0111.pdf) [hereinafter Staebler].

<sup>8</sup> *Id.*

<sup>9</sup> SBA generally requires that at least two, full-time members of the investment fund's management team have at least 5 years of successful private equity investment experience. *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> See section V, *infra*.

<sup>12</sup> 13 C.F.R. § 107.210(a) (1). SBA's "diversity requirements" for investors generally require that no investor own and control more than a 70% of capital in the fund. See 13 C.F.R. § 107.150.

<sup>13</sup> This includes a review of the applicant's business plan, financial projections, legal documents, and reference and background checks. Staebler, *supra* note 7, at 16; see 13 C.F.R. § 107.300.

<sup>14</sup> 13 C.F.R. § 107.305.

<sup>15</sup> Staebler, *supra* note 7, at 16.

<sup>16</sup> *Id.*

move forward with the formal application.<sup>17</sup> After obtaining the minimum required capital and filing a formal application, a fund that plans to continue a similar investment strategy may be eligible for a “fast track” licensing process designed to shorten the final application process to less than six months.<sup>18</sup>

### III. How the Program Works

The debenture SBIC program<sup>19</sup> is made up of private investment funds licensed as SBICs that combine SBA leverage with their private capital to form a pool with which to invest in small businesses. SBA leverage is capital provided to the SBIC through the federal guarantee of the SBIC’s debentures,<sup>20</sup> which are the debt instruments sold by the SBIC to private investors.<sup>21</sup> The combining of leverage with private capital allows the SBIC additional funds for investing than it would otherwise have obtained solely through its own efforts to raise capital.

SBICs are limited in the amount of SBA leverage they can pair with private capital. For individual license-holders, leverage may be drawn<sup>22</sup> in an amount of no more than three times the fund’s amount of private capital, or a maximum of \$150 million.<sup>23</sup> Licensees controlling multiple funds may draw no more than an aggregate of \$225 million.<sup>24</sup>

---

<sup>17</sup> In this examination, SBA analyzes “the similarity of the business plan, management team, track record, profitability, liquidity, and prior SBA compliance record.” *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Congress created two types of SBICs – debenture and participating securities. The primary difference between the two relates to how the SBA is repaid for the funds that it provides the SBICs. Since no new participating securities SBICs have been licensed since 2004, the hearing and this memorandum focuses on the debenture SBIC program. In addition to conventional debenture SBICs, the SBA created, pursuant to President Obama’s Startup America Plan, two other types of SBICs that operate within the confines of the overall debenture SBIC program – early stage SBICs and impact investment initiative SBICs. The former provide funds to early stage small businesses and the latter invests in low-income areas. It is unclear whether the SBA has the authority to create such specialized debenture SBICs under Title III of the Small Business Investment Act. Irrespective of SBA’s authority, the early-stage and impact initiative SBICs must comply with the overall rules governing debenture SBICs. See <http://www.sba.gov/sites/default/files/Early%20Stage%202013%20FAQs.pdf> for information on early stage SBICs; see <http://www.sba.gov/taxonomy/term/19341> for information on impact investment initiative SBICs.

<sup>20</sup> 13 C.F.R. §107.50. The additional capital provided by the private purchasers constitute the leverage that the SBIC can use to invest in small businesses. Investors are willing to purchase the debentures because the government guarantees their repayment.

<sup>21</sup> Interest rate is determined by Secretary of Treasury based on the current average market yield on outstanding obligations. See 15 U.S.C. § 683.

<sup>22</sup> SBICs obtain leverage via a “leverage commitment” issued by SBA, from which they subsequently draw. Leverage commitments may be obtained at the time of licensing, or as needed thereafter, and during the issuance of each commitment, the SBIC pays a fee equal to three-percent of the amount of leverage issued, and an annual charge on the amount of leverage not to exceed 1.38%. See 13 C.F.R. §107.1130.

<sup>23</sup> *Id.* at §107.1150

<sup>24</sup> *Id.*

SBICs may use their combination of leverage and private capital to invest in small businesses<sup>25</sup> that qualify as small under SBA size standards, or have less than \$18 million in net worth and average annual revenues over the previous two years of no more than \$6 million.<sup>26</sup> In addition, SBICs must invest at least 25% of their total capital in “smaller businesses,” defined as having less than \$6 million in net worth and average annual revenues of no more than \$2 million over the previous two years.<sup>27</sup>

Over the course of investing in small businesses, the SBIC must pay back SBA for the leverage it received.<sup>28</sup> A SBIC is able to prepay the amount of a debenture any time after issuing it to a small business, but it must be paid in full.<sup>29</sup> To ensure the SBA is repaid for its issuance of leverage, over the course of their investment periods, SBICs eventually work out a plan with the agency that indicates how the SBIC plans to liquidate its assets and repay the SBA for leverage drawn.<sup>30</sup> When receiving proceeds from an investment, SBICs may either recycle the gains into new or supplemental investments, or distribute proceeds to limited partners (LPs) if the fund exhibits financial performance measures that indicate the ability to do so while remaining financially stable.”<sup>31</sup>

#### IV. SBIC Oversight

SBA is responsible for oversight of SBIC licensees. To maintain their license, SBIC funds are responsible for compliance with program eligibility requirements that include numerous reporting requirements.<sup>32</sup> To ensure compliance with the regulatory requirements, SBA conducts periodic examinations to ensure that funds are not placing the government at undue risk as a result of their investments.<sup>33</sup>

SBA also exercises oversight of funds through its control on the issuance of leverage. The SBA only will issue leverage (even if the SBIC has purchased a commitment for leverage) when the SBIC demonstrates that it needs the leverage.<sup>34</sup> Finally, the SBA can stop the SBIC from making investments if the investment losses are sufficiently severe to place the company in what the SBA terms “capital impairment.”<sup>35</sup> This means that SBA has the authority to restrict the payout that the

---

<sup>25</sup> SBICs may invest in small businesses located in the United States not deemed contrary to the public interest. In addition, re-lenders, financial companies, passive businesses, and real estate businesses are not permitted to receive SBIC investment. *Id.* at §107.720.

<sup>26</sup> *Id.* at §121.301.

<sup>27</sup> *Id.* at §107.710.

<sup>28</sup> Repayment terms and conditions of debentures are spelled out in each individual debenture. SBA Form 444C serves as a model debenture and is available at: [http://www.sba.gov/sites/default/files/inv\\_debenture\\_certif.pdf](http://www.sba.gov/sites/default/files/inv_debenture_certif.pdf).

<sup>29</sup> <http://www.sba.gov/content/investing-with-sbic>.

<sup>30</sup> Staebler, *supra* note 7, at 6.

<sup>31</sup> The SBA permits distributions to LPs when the fund has a positive reading of “Retained Earnings Available for Distribution” or “R.E.A.D.” This is calculated as net retained earnings minus unrealized depreciation. *Id.*

<sup>32</sup> 13 C.F.R. §§ 107.630-680.

<sup>33</sup> *Id.* at § 107.690.

<sup>34</sup> *Id.* at § 107.120(a).

<sup>35</sup> SBA measures capital levels of the fund by adding the amounts of its undistributed net realized earnings, non-cash gains, and unrealized gains, then dividing by amount of regulatory capital (private capital raised by the fund) and multiplying by

fund can distribute to investors. SBA also has the authority to place a fund in receivership, taking control of the fund and winding it down in a way that protects the taxpayers.

## V. Standard Operating Procedures

In addition to statute and regulations,<sup>36</sup> SBA issues standard operating procedures (SOPs) that provide step-by-step guidance to program participants on how to comply with program requirements.<sup>37</sup> There is no requirement that SBA consult with the public or program participants prior to issuing an SOP, and the agency does not treat the SOPs as regulations subject to notice and comment rulemaking.<sup>38</sup> Thus, it remains unclear whether the agency needs to comply with its own SOPs or can ignore them.<sup>38</sup> As a result, it remains a major issue of contention whether the SOPs actually are rules, whether the SBA must adhere to the SOPs and whether the SOPs should be subject to the notice and comment procedures of the Administrative Procedure Act since outside lenders and SBICs must adhere to the SOPs.

The SOPs for the SBIC Program govern the structure of SBA's Investment Division and the operational requirements for SBIC licensees. However, the SBIC license application process also requires the applicant to complete several forms including an extensive MAQ which includes over 400 questions about the structure of the fund and its investment strategy.<sup>39</sup> The SOP for SBIC license application 10 04, issued in 1985, does not cover applications for the participating security program (which commenced operation in 1992), and specifies procedures long-abandoned by the SBA. Despite the SOPs, SBA lacks procedures for determining the initial licensing process for SBICs, leaving applicants confused about the review process and SBA vulnerable to criticism that its process for approval of a license is arbitrary. Without a uniform, standardized grading system used during the licensing process, the IC is forced to make licensing decisions on an ad-hoc basis.

## VI. Conclusion

Through a unique public-private partnership, the SBIC Program has provided billions of dollars to small businesses. To ensure its continued success, the SBA needs to regularize and codify the SBIC licensing process in the manner that it performs oversight. Increased clarity surrounding this process will be vital to increasing further the number of successful investment fund managers that seek SBIC licenses, driving additional capital to small businesses.

---

100. A fund is considered to be in capital impairment if this percentage is equal to or greater than 75%. *Id.* at §§ 107.1830-.50.

<sup>36</sup> The Small Business Act and the Small Business Investment Act of 1958 provides SBA's Administrator with the authority to promulgate rules and regulations to carry out its statutory authority.

<sup>37</sup> <http://www.sba.gov/about-sba-services/7481>.

<sup>38</sup> A detailed discussion of the authority that is encompassed in the SOPs is beyond the scope of this memorandum. However, interested parties should examine *United States v. Mead Corp.*, 533 U.S. 218 (2001) and its progeny as an entry point to consideration of this issue.

<sup>39</sup> SBA, SBIC MANAGEMENT ASSESSMENT QUESTIONNAIRE AND SBIC LICENSE APPLICATION (Form 2181), available at <http://www.sba.gov/sites/default/files/SBA%20Form%202181.pdf>.