STATEMENT OF STEVE CHARLES

CO-FOUNDER, IMMIXGROUP, INC.

"SIZING UP SMALL BUSINESS: SBA'S FAILURE TO IMPLEMENT CONGRESSIONAL DIRECTION"

BEFORE THE

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON CONTRACTING AND WORKFORCE

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 4, 2015

INTRODUCTION

Chairman Hanna, Ranking Member Takai, and Members of the Subcommittee, thank you for the opportunity to testify on issues related to small business contracting and size standards. My name is Steve Charles and I am the co-founder of immixGroup, where for two decades I have worked to help technology manufacturers succeed in the government marketplace, in concert with their small business partners. I have also long provided training and thought leadership on these issues, including co-authoring *The Inside Guide to the Federal IT Market*, a comprehensive resource for technology companies interested in doing business with the government.

immixGroup is a small business success story. Since our founding in 1997, immixGroup has grown into a recognized leader in the public sector IT marketplace, representing more than 250 leading technology manufacturers and working with more than 600 value-added resellers, solution providers, service providers, and other public sector channel partners to bring the latest software and hardware solutions to the federal government.

We are a top ten IT 70 GSA Schedule contractor with sales in Fiscal Year 2014 of over $420 million. We consistently have received awards and recognition for accomplishments in the technology industry, including, most recently, being named a BGov200 Top Federal Industry Leader and a Washington Post "Top Place to Work." On March 31, 2015, immixGroup was acquired by Arrow Electronics Inc., a Fortune 200 company and is a wholly owned subsidiary of Arrow Enterprise Computing Solutions, Inc. Moving forward, immixGroup looks forward to continuing its involvement in small business (and related) procurement issues on behalf of our small channel partners to help ensure clarity and consistency in existing regulations.

As a company heavily invested and experienced in the government acquisition process and the supply of technology products, immixGroup has a track record of success as an IT reseller. We have long been thought leaders on small business and contracting issues and work collaboratively with Congress and federal agencies, including the U.S. Small Business Administration (SBA). We truly appreciate the opportunity to share our thoughts with the Subcommittee this morning.

IMPORTANCE OF SIZE STANDARDS

It is critically important for the federal government to have small business size standards that accurately represent industry sectors for several reasons: (1) size standards determine business' eligibility to compete for contracts set-aside for small businesses; (2) size standards set eligibility for government programs reserved for small business concerns; and (3) size standards must be accurate to ensure government small business goaling targets are accurately tracked and reported. Thus, modifications to SBA size standards can have significant implications for SBA programs, federal procurement, agency rulemaking, any federal programs that deal with small businesses, and, of course, contractors.

The SBA uses the North American Industry Classification System (NAICS) as a basis for its size standards, which apply to all Federal government programs, including procurement. As the standard for all government acquisition, NAICS codes must be accurate and keep pace with industry norms to ensure the government is, indeed, working with a small business. NAICS codes are also critically important for the accurate tracking and reporting of federal spending because they are also used to identify the goods or services the government is purchasing. Incorrectly classifying an acquisition through the use of a wrong NAICS code can skew important data that inform policy decisions.

For this reason, immixGroup supports efforts to ensure that the SBA's review of size standards and NAICS code updates are done in a statutorily correct, transparent, and thorough manner. This is why a mechanism to formally challenge a size standard through the SBA Office of Hearings and Appeals—such as proposed in *Stronger Voice for Small Business Act of 2015* (H.R. 1429), introduced by Representative Mike Bost (R-IL) and cosponsored by our Congressman Representative Gerry Connolly (D-VA), is an important step moving forward. immixGroup also appreciates Chairman Steve Chabot's Small Contractors Improve Competition Act of 2015 (H.R. 1481), which would ensure that persons may file with the Office of Hearings and Appeals (OHA) petitions or reconsiderations of a size standard revised, modified, or established by the SBA Administrator.

THE NEED FOR DATA IN SIZE STANDARD EVALUATIONS

A key concern of immixGroup is the need for improved data as part of the size standard review process. By way of example, we need look no further than the SBA's recent proposed rule, "Small Business Size Standards: Industries with Employee Based Size Standards Not Part of Manufacturing, Wholesale Trade, or Retail Trade (RIN 3245–AG51)." This proposal, in addition to updating industry size standards, would eliminate the Information Technology Value Added Reseller 150-employee size standard exception and Footnote 18 (collectively referred to hereafter as the "IT VAR exception") from SBA's table of size standards under NAICS 541519. As discussed in immixGroup's comments to the proposed rule, available here,[1] we strongly support the SBA's end objective of striking the Footnote 18. We appreciate that this Committee has expressed strong reservations with the SBA's process in developing the proposed rule. Our hope is that, for reasons discussed below, issues related to Footnote 18 can be resolved in a way that promotes certainty and clarity within the procurement system.

By way of background, NAICS 541519 is a "services" code titled "Other Computer Related Services" falling under the "Professional, Scientific and Technical Services" section of the SBA Table of Size Standards. The IT VAR exception requires a contract to be comprised of at least 15 percent and not more than 50 percent of value added services (VAS). By extension, the contract must then consist of at least 50 percent and not more than 85 percent products. Thus, by definition, services under the IT VAR exception can never comprise the majority of a procurement. In other words, under 541519 Footnote 18, supplies must comprise the majority value while being reported as services in the government's procurement data system.

In the SBA's proposal, the Agency notes that that "the lack of data on characteristics of firms involved in IT VAR activities to evaluate the current 150-employee size standard also justifies SBA's proposal to eliminate the IT VAR sub-industry category." Indeed, immixGroup is not aware of any research that has been conducted to date on these issues. However, based on our experience, we firmly believe that if a non-partisan, independent review were conducted on

[1] http://www.regulations.gov/contentStreamer?documentId=SBA-2013-0010-0211&attachmentNumber=1&disposition=attachment&contentType=pdf

recent solicitations using the IT VAR exception—with a focus at the delivery order level on the total value (amount) of products, labor hours, and fixed utilization —this research would clearly show how agencies' use of the exception has been confusing and misguided, and that it has in turn inhibited the ability of otherwise qualified small contractors to compete for federal IT products.

We believe that a thorough review of orders under the IT VAR exception as part of the proposed rulemaking would—in addition to being appropriate due diligence and providing added certainty—underscore the need to reform the IT VAR exception in the manner proposed recently by SBA.

BROADER SIZE STANDARD AND PROCUREMENT ISSUES

Reforming the IT VAR Exception

The IT VAR exception is a narrowly tailored footnote under a single IT services NAICS code, which applies only to small businesses that resell IT products. To our knowledge, it is the only footnote that creates a dual nature NAICS code and is, therefore, an anomaly.

Use of the IT VAR exception in small business set-asides has restricted competition and small business participation by allowing agencies to arbitrarily exclude qualified small businesses with more than 150 employees, when use of an available, applicable (and more appropriate) manufacturing NAICS code would not. Use of the more appropriate manufacturing (*i.e.* supply) based NAICS code, increases the small business size standard from 150 to 500 employees. For example, in an acquisition for laptop computers, a contracting officer should use a manufacturing NAICS code and size standard, such as NAICS 334111 (Electronic Computer Manufacturing). This NAICs code has [a] 1,000-employee size standard, to which the non-manufacturer (*i.e.*, reseller) size standard of 500 employees would apply by rule[2]. Use of NAICS 541519 Footnote 18 in this case: 1) excludes from competition a large segment of prospective small business contractors, which would be otherwise eligible and just as well equipped to deliver on these

[2] See, FAR 52.212-1(a)

contracts; and 2) violates a contracting officers obligation to designate a NAICS code that best describes the nature of the acquisition and the items being bought (*e.g.*, products v. services).[3]

Further, when competition is restricted, the government often ends up paying higher prices. In short, the practical effect of 541519 Footnote 18 contravenes SBA's fundamental policy of increasing small business participation and the government's essential goal of increasing competition. On the other hand, eliminating the IT VAR exception will increase small business participation by opening up government acquisitions to otherwise capable and qualified small businesses.

Additionally, by using NAICS Code 541519, Footnote 18, agencies avoid critical small business protections, including the "non-manufacturer rule" (NMR) and "performance of work requirements," which are intended to ensure that small business is the ultimate beneficiary of set-aside contracts, but which do not apply either by law or operation to acquisitions using a services code.

Further, restricting acquisitions for IT products to small businesses under the IT VAR exception eliminates the country of origin requirements of both the Trade Agreements Act (TAA) and Buy American Act (BAA) thereby granting China and other non-designated counties an avenue to supply products directly to the U.S. Government.

FAR Subpart 25.4 (Trade Agreements) is expressly exempted from acquisitions set aside for small business[4] and commercial item IT is specifically exempted from the BAA.[5] As the NMR does not apply to contracts assigned a services NAICS code the domestic preference protection in that regulation (*i.e*. the requirement to furnish the end item of a United States small business) is likewise eliminated.

By eliminating the IT VAR exception, SBA would resolve the "inconsistencies, confusion, and misuse" created by Footnote 18. First, it has become common for procuring agencies to use the

[3] 13 C.F.R. § 402(b)
[4] FAR 25.401(a)(1)
[5] FAR 25.103(e)

IT VAR exception under NAICS 541519 to designate multi-agency contracts (MACs) and government-wide acquisition contracts (GWACs) to buy COTS IT "products" (*e.g.*, hardware and software). In many cases, these delivery order contracts consist of less than the 15 percent value added services as required and thus, the solicitation should have been classified under the appropriate manufacturing (*i.e.*, supply) NAICS code. By using the IT VAR exception to classify these acquisitions federal agencies often confuse the principle purpose of the items being acquired (as required by SBA regulations) with the source of those items.

The IT VAR exception also breeds confusion and ambiguity because, by definition, an acquisition under it can never consist of a majority of services and often consists overwhelmingly of supplies. Yet, through use of the IT VAR exception, agencies classify procurements for supplies as services (task order) contracts. This contradicts the requirement in 13 C.F.R. § 121.402(b) that requires a contracting officer to select a NAICS Code that best describes the "principal purpose" of the acquisition. Further, when procurements are misclassified, it becomes very difficult to produce meaningful data, accurately track government spending, and formulate policy. An acquisition of IT products will look like one for IT services.

For these reasons, immixGroup was pleased that SBA identified the problems associated with the IT VAR exception and proposed to address and resolve these problems. We hope that the agency will finalize workable policy in an appropriately timely manner to ensure fairness, transparency, and accurate data reporting in the small business contracting space. We urge SBA and other agencies to continue to thoughtfully evaluate rules and regulations governing IT resellers.

Some opponents of the Footnote 18 elimination seem to completely misunderstand the IT VAR exception's limited applicability and impact, erroneously arguing that this change will somehow shut out every "mom and pop" business in every industry. In reality, however, this is a narrowly tailored footnote under a single IT services NAICS code, which applies only to small businesses that resell IT products. Again, it is an anomaly in the size standard framework. The proposed change does not impact all industries or businesses and hardly sounds the death knell for SBA or U.S. small business.

We do, however, understand some of the opposition's concerns. The elimination of the IT VAR exception and corresponding 150 employee size standard may instantly make some of these small business resellers large for acquisitions of IT services under NAICS code 541519's current revenue based small business size standard of $27.5 million. However, for acquisitions where the majority of the dollar value is spent on products, these resellers would remain small under the 500 employee size standard for non-manufacturer resellers under an applicable manufacturing NAICS code.

We take no position on what the appropriate small business size standard should be under NAICS 541519 – Other Computer Related Services.

Rather, our message is that SBA's proposed elimination of the only dual nature and arbitrary NAICS code will lead to clarity for industry, force agency compliance with current SBA regulations, eliminate serious loopholes that work to the detriment of small business and allow government to accurately track spending both in terms of small business goaling and what is actually being purchased within the framework of the NAICS.

Non-Manufacturer Rule and the Failure of Government Set Asides

Related to SBA's IT VAR exception proposal, on December 29, 2014, SBA released another proposed rule to implement proposed clarifications to the NMR and clarifications regarding the nature of COTS software (Small Business Government Contracting and National Defense Authorization Act of 2013 Amendments (RIN 3245–AG58)). immixGroup supports addressing the problems associated with the real-world operation of the NMR and SBA's proposed clarification that COTS software is and should be treated as an item of supply; however, we recommended to SBA in our comments that it go further to clarify that acquisitions using NAICS 511210 for COTS software are then subject to the 500 employee (non-manufacturer) small business size standard under FAR 52.212-1(a) and FAR 19.102(f).

In designating a NAICS code, the procuring agency is required to select "the NAICS code which best describes the principal purpose of the product or service being acquired."[6] Where both products and services are being acquired, acquisitions must be classified according to the component which accounts for the greatest percentage of contract value." Once properly assigned, the NAICS code has a corresponding size standard, which is represented by either a dollar figure (*i.e.*, annual receipts) or number of employees (*i.e.*, headcount).

When a procurement is restricted for small business, accurately representing size status against the standard applicable to the NAICS code identified in the solicitation, however, is only the first (and perhaps the easiest) step for a non-manufacturer reseller. Once the contractor's size status is appropriately determined and certified as small, the contractor still must comply with other SBA regulations, such as the NMR.

The NMR sets out the requirements for resellers to provide supplies under a small business set-aside. The NMR applies only when: 1) the procurement is set aside for small business; and 2) the procurement has been assigned a manufacturing or supply NAICS code. In such cases, the reseller must, among other things, have fewer than 500 employees and, in the absence of a waiver under 13 CFR 121.406(b)(5), furnish the end item of a U.S. small business.

While the rationale behind the NMR is to prevent large business from using small business as a front that simply passes through the majority of the government's small business contracting dollars to a large original equipment manufacturer (OEM), frequently—and especially in the IT market—the items desired by the government are manufactured only by large business.

Thus, while government agencies want to buy from small business, the IT products government agencies desire are not <u>made</u> by small businesses but, rather, are only <u>sold</u> by small businesses. Typically, large OEMs (*e.g.*, IBM, Oracle, and McAfee) sell commercially (and to the public sector) through a network of resellers and distributors known as channels of distribution (*i.e.* the "channel"). Some OEMs employ wholesale distributors, who sell to resellers, who then sell to

[6] 13 C.F.R. § 402(b)

the end user government customer. This is commonly referred to as a "two-tier" channel model. Other OEMs simply sell to resellers, who then sell to the end user government customer.

Given the structure of the IT supply chain, the practical application of the NMR, which requires resellers to provide the end item of a U.S. small business, makes almost any set-aside for IT products defective in the absence of an applicable (and rarely obtained) waiver. Where a procurement for IT products is reserved for small business, it is virtually impossible for any small business prime to perform the requirements of the contract without violating the NMR.

immixGroup sees dozens of delivery orders each week restricted for small business, yet at the same time specifying a name brand product manufactured only by a large OEM. In the absence of an applicable waiver, we believe such procurements are defective because no non-manufacturer reseller could provide the end items of a U.S. small business.

This puts small business government contractors in an untenable position. First, the awardee (or offeror) can approach the Contracting Officer and explain the existence and application of the NMR. Some Contracting Officers are receptive to that explanation and will restructure the acquisition, usually reclassifying it as full and open. Other Contracting Officers refuse to discuss the issue or modify the solicitation.

Second, if the award remains set-aside, the contractor could protest the award – something unheard of, since winning bidders typically do not protest. In any case, this is not a viable option when considering business realities and valued relationships with OEM suppliers, whose products were listed in the delivery order or on the solicitation.

Third, the contractor could comply with the NMR and not bid on the opportunity or accept the award. This is also an unrealistic position as, once again, ongoing business realities and relationships with OEM suppliers come into play.

This leaves the fourth and final option – the contractor could accept the order and knowingly breach the NMR. While it is unclear whether a violation of the NMR by a contractor is the same

as a misrepresentation of size status subject to the strict liability and presumption of loss penalties of the *Small Business Jobs Act of 2010* (we think it is not), we do certainly see any violation of SBA regulations as serious and subject to substantial penalty.

The issue of the NMR reflects an ongoing misunderstanding of the structure of the government's IT supply chain. Specifically, set-asides for IT product solicitations lead only to confusion, uncertainty and potential liability – and not to increased small business participation or protection.

Modernizing Size Standard Classifications for IT Products

SBA's December 2014 proposed rule also seeks to clarify the nature of COTS software. immixGroup strongly supports SBA's direction in this regard and believes there has long been confusion and uncertainty about how to properly classify COTS software and, consequently, how to apply the NMR in set-aside acquisitions for such items. We view this as extremely significant given that in FY 2014 on the GSA IT 70 MAS contract alone, the Government purchased over $14.15 billion worth of software and related maintenance and support.

The SBA's current Table of Size Standards contains only one NAICS Code that describes the processes of programming, developing, selling and supporting software – 511210 ("Software Publishers"), which is currently characterized as a "service" indicated by its revenue based small business size standard.[7] This NAICS code falls under "Sector 51 – Information" and not under a manufacturing or a services NAICS code. However, the true nature of COTS software is much closer to that of a commodity (*i.e.*, a "supply" or "product") than a service. For instance, Microsoft Word is a productivity tool, not a service. It requires no people or labor hours to deliver to a customer. It is analogous to book publishing, which is accurately classified as a product. Software development, on the contrary, does require professional services (labor hours) and should be classified as such under Sector 54—Professional, Scientific and Technical Services.

[7] Items of supply (*i.e.*, products) are designated in SBA's Table of Size Standards by employee based size standards whereas services are designated by revenue based size standards.

In our comments to the SBA, which are available here,[8] immixGroup hopes SBA will go a step further to specifically explain that because COTS software is to be treated as a supply, the 500 employee small business size standard for non-manufacturers under 52.212-1(a) and FAR 19.102(f) would apply to acquisitions for COTS software utilizing 511210 and not the $38.5 million revenue-based standard.

Further, having only one software-based NAICS Code is insufficient to accurately categorize and describe the three different software industries that exist in the commercial market today. COTS, Cloud, and Developmental items should not be lumped into one "catch-all" category as they each are of a different nature and thus require unique NAICS Codes. immixGroup urges the Administration and Congress to take appropriate actions to address this issue and we stand ready to be a resource.

THE GSA's TRANSACTIONAL DATA REPORTING PROPOSAL AND THE BURDEN POSED TO SMALL CONTRACTORS

Finally, we would like to take this opportunity to share with the Subcommittee our perspective on the General Services Administration's (GSA) March 4, 2015 proposed rule, *General Services Administration Acquisition Regulations: Transactional Data Reporting* (GSAR Case 2013-G504), which would establish a new transactional data reporting clause. This clause would require GSA Schedule contractors to report monthly on prices paid by ordering activities for products and services through what GSA describes as a "user-friendly, online reporting system."

The proposal would also remove the Basis of Award monitoring requirement of the existing Price Reductions Clause ("PRC"), which requires contractors to track its commercial sales to a defined customer (or category of customers) agreed upon at the time of contract award to ensure the government's pricing remains less than or equal to the prices charged those commercial customers. The proposed rule would not do away with Commercial Sales Practices ("CSP")

[8] http://www.regulations.gov/contentStreamer?documentId=SBA-2014-0006-0119&attachmentNumber=1&disposition=attachment&contentType=pdf

disclosures, which document the pricing, terms, and conditions a vendor offers to its commercial customers in order to determine a fair and reasonable price at the GSA contract (catalog) level.

immixGroup applauds GSA's recognitions that: (1) the market and competition drive pricing; and (2) the PRC is confusing, burdensome, and ineffective. However, immixGroup believes that GSA's proposed rule replaces an existing burdensome data collection process with a new, more onerous process and misses an opportunity to address broader systemic problems. As noted by the Coalition for Government Procurement (CGP), the GSA proposal as currently written would impose on industry significant time, price monitoring, tracking and reporting burdens on a monthly basis—well beyond GSA's estimates. According to the CGP, the cumulative cost of the reporting burden imposed by this rule would be 30 times that of GSA's estimate in year one of the proposal.

SBA Office of Advocacy Cautions GSA on Proposed Rule

The SBA Office of Advocacy, the "Regulatory Watchdog" for small business, submitted comments to GSA on the proposed transactional data rule.[9] The Office of Advocacy recommended postponing the rulemaking to conduct a formal stakeholder outreach process throughout the country. During this delay, the Office of Advocacy also urged GSA to conduct a more detailed impact assessment of this proposed rule on small businesses and take into consideration the rate of small business participation in the acquisition process and not just focus on the percentage of dollars being awarded to small businesses. This assessment should also include an examination of the potential unintended consequences of this rule on small business resellers because the lack of data in the Initial Regulatory Flexibility Analysis (IRFA) makes it unclear how GSA will balance the potential conflict between small businesses that are on a GSA schedule who are also value added resellers to the same original equipment makers who are also on GSA schedules. The Office of Advocacy's comments reflect concerns expressed by small businesses that the IRFA for this transactional data collection and reporting rule does not provide them with a clear understanding of GSA's legal framework moving forward and concerns over

[9] See Advocacy's complete comments at https://www.sba.gov/category/advocacy-navigation-structure/legislative-actions/regulatory-comment-letters.

how transactional data will be collected as well as concerns about unintended consequences and burdens posed by the rule.

GSA's Proposed Rule Does Not Address the Conundrum of Its Statutory Authority

In addition to concerns about regulatory burdens shared by the Office of Advocacy, immixGroup believes that GSA's statutory authority must be modified to allow achievement of the "lowest overall cost alternative" either at contract level or order level, but not require both. (See 41 U.S.C. §152). In truth, order level, competitive pricing, not catalog pricing, is where ordering activities realize the lowest overall cost. immixGroup encourages GSA to consider building on its efforts to maximize competition rather than adding burdensome tracking and reporting obligations. GSA needs to recognize that order level competition, orchestrated by actual buyers with funded requirements, ensures the government receives the "lowest overall cost alternative" (just like the commercial world).

It is illogical for contract catalog pricing on multiple award, non-mandatory contracts with ordering procedures that require competition at the order level to be the lowest available cost alternative.

The obligation to provide CSP disclosures goes toward justifying and negotiating fair and reasonable pricing at the catalog level. This is the fundamental problem and current bottleneck of the GSA Schedules program. Vendors cannot and will not provide anyone (the U.S. Government included) their best pricing for a quantity of one with no purchase commitment that is then also visible to the entire world via the Internet.

CSPs do not serve either government or industry well in establishing catalog pricing and are not necessary for GSA to deliver the "lowest overall cost alternative," because the real savings, indeed the lowest overall cost alternative (as GSA acknowledges), comes from order level

competition. The obligation to disclose CSPs results in undue confusion and burden for both parties and delay in making available the cutting edge technology ordering activities desire.[10]

Artificial mechanisms like CSPs and the PRC have not, and will not, result in end customers receiving the lowest overall cost alternative.

GSA must evolve its thinking and processes from an antiquated notion of the importance of contract level pricing to a modern framework of ensuring transparent order level competition among carefully vetted suppliers under pre-negotiated terms and based on catalogs that are current to the day. It should also involve the Office of Inspector General and the relevant Congressional oversight committees in this conversation as this approach represents a real departure from the status quo.

We suggest Congress work to amend the relevant statutory language to allow for the lowest cost alternative either at the contract level or ordering level. This would provide GSA the authority to rely exclusively on order level competition to ensure fair and reasonable pricing and the ability to discard the inefficient and burdensome CSP disclosure requirement in favor of a more nimble method of adding and updating products and pricing to its catalogs.

CONCLUSION

In conclusion, immixGroup thanks the Subcommittee for considering common sense measures to ensure that SBA conducts size standard evaluations in a transparent, data-driven manner that fully complies with the letter of the law and which results in the size standards that best represent the nature of the industry in question. By giving a small businesses the opportunity to challenge an inappropriate SBA size standard through the SBA Office of Hearings and Appeals, H.R. 1429 would certainly further this goal.

Above and beyond statutory and procedural issues surrounding size standards, immixGroup believes that additional items of concern—such as the elimination of the IT VAR exception,

[10] In our experience it could take six (6) months or more to get items on our GSA Schedule compared to two days on other GWACs, which are not hindered by the same statutory mandate to negotiate pricing at the catalog level.

clarification of the NMR (and nature of COTS software), and the need for additional NAICS codes to accurate describe the different kinds of commercial software outlined above—also reflect the need to craft size standards in a way which complies with applicable statutes and promotes clarity.

Again, thank you Chairman Hanna and Ranking Member Takai for the opportunity to testify. I would be pleased to answer any questions you or members of the Subcommittee may have.