STEVE CHABOT, OHIO
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

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

Memorandum

To:	Members, Subcommittee on Health and Technology
From:	Committee Staff
Date:	January 11, 2016
Re:	Hearing: "Oversight of the Office of Investment and Innovation at the SBA"

I. Introduction

On Tuesday, January 12, 2016 at 3:00 p.m. the Subcommittee on Health and Technology will conduct a hearing titled, "Oversight of the Office of Investment and Innovation at the SBA." This is the fifth in a series of oversight hearings conducted this month by the Committee on Small Business examining various aspects of the Small Business Administration's (SBA or Agency) adherence to Congressional mandates and its own general operating procedures, as well as providing oversight of several non-Congressionally authorized programs initiated by the Agency. The hearing continues an examination of a recently released Government Accountability Office (GAO) report[1] detailing management deficiencies throughout the SBA.

II. Office of Investment and Innovation (OII)

The OII at the SBA manages the agency's Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs. The OII also administers the Small Business Investment Company (SBIC) program, a portfolio of public-private partnerships comprised of about 300 principal investment funds with over $23 billion in growth capital. With authorization to invest $4 billion annually, the SBIC program operates at a zero-subsidy cost to the American taxpayer.[2] A portion of the overall SBIC funds are dedicated to the Impact and early stage funds. The OII also administers the Growth Accelerator Fund Competition.

[1] GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES (GAO-15-347), (2015) available *at* http://www.gao.gov/products/GAO-15-347 [hereinafter "GAO Management Report"].
[2] A zero subsidy rate occurs when a government program generates sufficient revenue through fee collections and repayment of funds to not require appropriations to issue new investments.

III. Congressionally-Directed Programs Overseen by the OII

A. SBIR and STTR Programs

In order to increase participation of small businesses in federal research and development (R&D) efforts, Congress passed the Small Business Innovation Development Act in 1982,[3] which established the SBIR program. The purpose of the Act was to increase government funding of small businesses that conduct research and development (R&D) with a particular focus on technology that has high commercial potential. The program requires federal departments with an extramural research budget of $100 million or more to set aside a small percentage of their agency's overall research budget and award technology development contracts to small firms. The percentage of research and development activities to be conducted by small firms originally was set at 1.25 percent but has increased incrementally to 3.0 percent where it now stands. Since 1982, Congress has continued to make significant changes to the SBIR program, including increasing award sizes for inflation, codifying agency independence within a framework established by the SBA, increasing the percentage participating agencies must set aside for the program, and increasing the general focus of the program on the commercialization of the technologies developed.

The STTR program also expands funding opportunities in the federal innovation R&D arena. Central to the program is expansion of the public/private sector partnership to include joint venture opportunities for small businesses and the nation's network of nonprofit research institutions. Much like SBIR, STTR is a highly competitive program that reserves a specific percentage of federal R&D funding for awards to small businesses and nonprofit research institution partners.

Congress delegated to the SBA the authority for creating broad policy and guidelines under which qualifying agencies operate their SBIR and STTR programs. The SBA monitors, and is required to report to Congress on the conduct of, the separate departmental SBIR and STTR activities. While the SBA provides direction and monitors the program, it does not provide funding for the awards, select the award winners, or distribute the award dollars.

B. Small Business Investment Company Program

SBICs are for-profit enterprises organized under state law as either a corporation or partnership or a variant thereof. SBICs receive a license to operate from the SBA pursuant to authority in Title III of the Small Business Investment Act of 1958. The SBA may not grant a license until it is satisfied that the licensee has: a) sufficient capital to operate soundly and profitably; and b) has qualified management.[4] If the SBA is satisfied with these aforementioned determinations, then the agency, prior to issuing a license, must consider whether: a) there is a need for investment in the area in which the applicant will operate; b) the reputation of the owners of the applicant; and c) the prospect that the ownership will

---

[3] Pub. L. No. 97-219, 96 Stat. 217 (1982) (codified at 15 U.S.C. §638, as amended).
[4] 15 U.S.C. § 681(c)(3)(A).

manage the business in a profitable manner. Essentially, the licensing process requires the SBA to consider the business plan of the SBIC before issuing a license.[5]

Once licensed, the SBIC is able to use leverage provided by the federal government to invest in small businesses.[6] There are three types of SBICs: Conventional, Impact, and Early Stage. Funds have been licensed as Conventional Licensees since the program was founded in 1958. They have the broadest investment mandate, are licensed through a rolling admissions process and are eligible for two tiers of leverage capped at $150 million and obtaining a license can take up to two years. The Impact License is for funds with an investment mandate targeted to social as well as financial returns. The managers of these funds pledge to invest 50 percent of their capital in 'impact' investments and are eligible for an expedited licensing process. The Early-Stage License is designed to attract investment fund managers with experience supporting companies in their earliest stages of growth. They have access to one tier of leverage, capped at $50 million and are licensed through an annual call (issued in December or January of each year) rather than on a rolling basis. Neither the Impact nor Early Stage Funds have a specific authorization from Congress.

IV. Management Challenges in the Office of Investment and Innovation

A. Failure to Take Actions Mandated by Congress

As a federal agency, the SBA only has powers to the extent that Congress delegates an agency powers set forth in statute. The converse of this delegated authority is that the Executive Branch, under Article II of the Constitution, is required to promptly and faithfully execute the powers delegated to it by Congress.[7] The Committee has found a number of instances in which the Agency has failed to execute its responsibilities under Article II of the Constitution.

Congress last reauthorized the SBIR and STTR programs in December, 2011.[8] Among other things, this legislation reaffirmed the requirement that the SBA produce a yearly report to Congress on the SBIR and STTR programs of the Federal agencies and the

---

[5] *See* 13 C.F.R. § 107.130.

[6] For every dollar of private investment, an SBIC is entitled to draw up three dollars in government funding (but is not required to draw that maximum amount). Rather than simply borrowing directly from the federal government, SBICs sell securities that are sold in the private market (essentially a loan by private investors to the SBIC) and the federal government guarantees that the "lenders" to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage. In essence, there are two separate "loan" transactions; a loan of leverage by the SBA to the SBIC and a loan of private funds by investors to the SBIC who receive either a debenture to the total value of funds provided by the private investors as "collateral." The SBA guarantees the repayment of the funds provided to the SBIC by the private investors who purchased the leverage

[7] *Loving v. United States*, 517 U.S. 748, 758 (1996). Congress is so concerned with prompt execution by federal agencies that it authorizes challenges by aggrieved parties when an agency unreasonably withholds agency action. 5 U.S.C. § 706(1). The SBA should be intimately familiar with the requirement for prompt action since the SBA was compelled by a federal district court to take actions needed to implement a women's procurement program for which SBA had taken almost no action for five years. *U.S. Women's Chamber of Commerce v. SBA*, 2005 U.S. Dist. Lexis 32,497 at * 54-*64 (D.D.C. 2005).

[8] Pub. L. No. 112-81, Div. E. 125 Stat. 1298, 1822-62 (2011). The short title of Division E is the SBIR/STTR Reauthorization Act of 2011.

Administration's information and monitoring efforts related to the SBIR and STTR programs.[9] Congress received no such individual reports from the SBA for Fiscal Years 2009 through 2011. Instead, the SBA compiled one report for those years and transmitted it to Congress in a full two years later in December 2013.[10] Similarly, the SBA failed to deliver the Fiscal Year 2012 report until November 5, 2014.[11] To date, the SBA has not produced or transmitted mandated reports for Fiscal Years 2013 through 2015. Despite these failures to report, the SBA used scarce resources to create two untested SBIC programs.

B. Failure to Implement Recommendations made by the Government Accountability Office (GAO)

The SBA's record in addressing GAO's recommendations also is lacking. At the end of each GAO report, whether they be mandated by law, requested by a Congressional Committee or an individual member of Congress, the GAO makes recommendations to help address any shortcomings or operational deficiencies they have uncovered at a particular agency. Since Fiscal Year 2000, there are still 69 open recommendations from GAO and, in the opinion of GAO, should be implemented.[12] In short, the SBA is continuously ignoring the advice of the GAO. Of those 69 open recommendations, no less than 11 would be implemented directly by the OII.

C. Use of Standard Operating Procedures

The SBA promulgates regulations but often those regulations do no more than merely parrot the language of the Small Business Act or Small Business Investment Act of 1958.[13] The SBA then supplements these regulatory directives in often mandatory language in documents designated by the SBA as standard operating procedures or SOPs. These documents are not issued pursuant to the procedures set out in the Administrative Procedure Act for the issuance of legally binding regulations nor are the public made aware of their issuance in the Federal Register.[14] As a result, the SBA can modify the operation of its programs through modification of SOPs without alerting the public, receiving input from the public in violation of the SBA's own rules,[15] or ignoring the SOPs altogether.[16] The

---

[9] 15 U.S.C. § 638(b)(7).

[10] E-mail from John D. Ford, Office of Congressional and Legislative Affairs, United States Small Business Administration, Dec.18, 2013 (on file with the Committee).

[11] Letter from Javier Saade, Associate Administrator, Office of Innovation and Investment, United States Small Business Administration, to The Honorable Sam Graves, Chairman, House Committee on Small Business (Nov. 5, 2014), *available at* https://www.sbir.gov/sites/default/files/sbirsttr_fy12_rpt_trans_ltr_graves.pdf.

[12] GAO Management Report, *supra* note 1, at 103-114.

[13] For example, the definition of "credit elsewhere" in § 3(h) of the Small Business Act, 15 U.S.C. § 632(h) is repeated nearly verbatim in the Agency's regulation, 13 C.F.R. § 120.101.

[14] Publication of agency rules in the Federal Register is required by the Freedom of Information Act or the agency cannot enforce those requirements. 5 U.S.C. § 552(a)(1). Such publication also is beneficial to an agency because such publication ensures that all individuals have legal notice of such requirements irrespective of whether they have actual notice. *Federal Crop Ins. Co. v. Merrill*, 332 U.S. 380, 384-85 (1947).

[15] Most SBA regulations address matters such as federal government contracts, loans, or benefits. For these rules, the APA exempts agencies from obtaining public comment when issuing such rules. However, the SBA has waived such an exemption and requires that it comply with the public notice and comment provisions of the APA. 13 C.F.R. § 101.108.

Committee has uncovered instances in which the SBA or its employees blatantly ignored the strictures of SOPs.

For example, the Agency issued a SOP for licensing SBICs in 1984 which was not modified until 2014 despite the fact that the SOP failed to address applications for new types of SBICs created after 1984. In fact, the SBA simply abandoned the procedures set out in the SOP at some point and suggested that licensees rely on the SBA website for procedures associated with filing SBIC license applications.[17]

V. SBA Initiatives

The SBA often fails to comply with Congressional directives. Rather than filing reports on SBIR as mandated by Congress, or complying with the Agency's own rules, the SBA decided that new initiatives without proper program evaluations imbedded into their creation was a better use of Agency resources. As noted earlier in this memorandum, neither the Impact nor Early Stage Funds have a specific authorization from Congress.

In 2014, the OII also initiated the Growth Accelerator Fund Competition. An accelerator is "a time-specific, mentorship-driven program designed to provide startups with critical resources to help them make rapid progress on product and customer development."[18] The stated goal of this program, as defined by the SBA, was to get an extra infusion of capital to qualified accelerators and the ecosystem in which they play, which, in turn, provides resources to boost the startup and entrepreneurship communities around them.[19]

There is no certainty that these programs will actually achieve their objectives. In fact, the number of applicants for licenses in the Early Stage Fund is so low that the Agency issued a contract to Bank of America/Merrill Lynch to assist the SBA in developing best practices needed to identify venture capital funds that would benefit from the program. Additionally, the contract also asked for assistance in reviewing SBIC applications, suggesting that the agency diverted resources from statutory licensing to its own initiatives such as the Growth Accelerators. This also raises questions about OII workforce planning since the OII may not have employees who can process ABIC applications.

The Committee (in various hearings on a bipartisan basis) and GAO[20] have both noted the absence of metrics in evaluating various entrepreneurial education initiatives created by

---

[16] For a complete discussion of the legal nature of SOPs and how the SBA abuses their use in violation of the APA and its own rules, see Letter from the Hon. Steve Chabot, Chairman, Committee on Small Business, to Ms. Mary Frias, Office of Capital Access, SBA at 39-44, 50-53 (Mar. 27, 2015) (on file with the Committee).

[17] The SBA undertook the update after numerous discussions with Committee staff pointing out that the Agency risked significant legal liability from a disappointed SBIC applicant if the Agency could not point to the procedures that the SBA followed in processing the application.

[18] Paula Andruss, *What to Look for in an Accelerator Program,* ENTREPRENEUR, Jan. 30, 2013, *available at* http://www.entrepreneur.com/article/225242.

[19] UNITED STATES SMALL BUSINESS ADMINISTRATION, OFFICE OF INVESTMENT AND INNOVATION, REPORT TO THE CONGRESS OF THE UNITED STATES 2014 GROWTH ACCELERATOR COMPETITION 4 (2015), *available at* https://www.sba.gov/sites/default/files/files/Growth_Accelerators_Report_to_Congress.pdf.

[20] *See* GAO, ENTREPRENEURIAL ASSISTANCE: OPPORTUNITIES EXIST TO IMPROVE PROGRAMS' COLLATIORATION, DATA TRACKING AND PERFORMANCE MANAGEMENT 21 (Aug. 2012) (GAO-12-819), *available at*

the Agency. The Committee has found that the SBA does not have adequate measures to evaluate the effectiveness of these efforts to direct SBICs to invest in specific areas of the country or in early-stage businesses. The SBA validated this concern by issuing an advanced notice of proposed rulemaking requesting input from the public on the value of early-stage business and whether it should be discontinued or modified.[21] The Committee remains concerned that the SBA extends itself to create new initiatives when so many of their Congressional mandates remain ignored.

VII. Conclusion

OII, like the rest of SBA, has shown several instances of mismanagement and lack of oversight of both their Congressionally mandated programs as well as their own initiatives. In addition, there are concerns that the SBA is overreaching its authority to create new programs such as the Impact or Early Stage SBIC funds. This hearing represents an opportunity for members to question SBA officials on these management deficiencies and the inner workings of various Congressionally and non-Congressionally mandated programs.

---

http://www.gao.gov/products/GAO-12-819; GAO, SMALL BUSINESS ADMINISTRATION, COSPONSORED ACTIVITIES CAN BENEFIT SMALL BUSINESSES BUT LACK A CONSISTENT FEEDBACK MECHANISM 13 (May 2014) (GAO-14-260), *available at* http://www.gao.gov/products/GAO-14-260.

[21] SBA, Small Business Investment Companies – Early Stage, Advanced Notice of Proposed Rulemaking, 80 Fed. Reg. 14,034, 14,035-37 (Mar. 18, 2015). Had the SBA established metrics, it would be able to assess the success of the initiative without relying solely on input from the public.