Small Business Administration Issues Call for Early Stage Managers

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Call Notice and Application Process

On January 12, the U.S. Small Business Administration (SBA) issued a "Call for Early Stage Fund Managers" (available at https://www.federalregister.gov/articles/2015/01/12/2015-00247/small-business-investment-companies-early-stage-sbics) in the *Federal Register*, inviting all interested early stage fund managers to apply for SBA's Early Stage Small Business Investment Company (SBIC) program. To be considered, all applicants must initially submit a management assessment questionnaire (MAQ). The MAQ provides information about the management team, the proposed investment strategy, the principals' track records and the proposed fund structure and economics. Based on an assessment of the MAQ, the managers may be invited to an interview at SBA. Fund managers that satisfy the criteria identified in the call, as determined by SBA's Investment Committee, will be issued a "green-light letter." The green-light letter permits the managers to submit a formal license application. Licensing requires approval by the SBA's Divisional Committee and its Agency Committee.

SBA will accept applications for Early Stage SBICs only at the times and in the manner specified in the call. An applicant wishing to be considered must file its MAQ by 5:00 p.m. on February 27, 2015. SBA will conduct interviews with the management of preliminarily selected applicants between April 20, 2015 and May 1, 2015 and will then make green-light letter decisions. SBA expects to make its green-light letter decisions by May 7, 2015. An Early Stage SBIC applicant that has received a green-light letter must file its license application by 5:00 p.m. on June 5, 2015 if it wishes to be licensed by September 30, 2015. All other applicants that have received a green-light letter must file their license applications no more than one year after the date of the letter. SBA will consider these subsequent applications as they are received. It is expected that SBA will publish a call notice for additional Early Stage SBICs for federal fiscal year 2016.

Before filing a formal license application, a fund must have at least $20 million of regulatory capital (as described below). The fund's capital commitments may only be conditioned upon receipt of an Early Stage SBIC license. The application must include the fund's and the general partner's organizational documents. Generally, a fund's limited partnership agreement will need to track the Early Stage SBA Model Limited Partnership Agreement, and the applicant must explain deviations from that model. In addition, the call sets forth a number of rules for certain types of provisions in the agreement. The Early Stage SBIC may be a wholly owned subsidiary of another fund (other than a business development company), provided that fund is organized in the United States. All principals must hold direct ownership interests in the general partner and receive carry directly from the general partner. Non-principals may not hold more than 25 percent of the carried interest. Any provision to remove or terminate a principal must be spelled out in the general partner's organizational documents and may not be tied to events occurring under other agreements. Side letters with fund investors are permitted only to the extent that they include provisions that supplement the fund's limited partnership agreement. Side letters may not supersede any provision in the fund's limited partnership agreement. SBA's prior written approval is required for all side letters.

SBA will generally evaluate applicants for Early Stage SBIC licenses using the same factors used for other SBIC applicants, but with a particular emphasis on the managers' skills and experience in investing in early stage companies. However, SBA reserves the right to maintain diversification among Early Stage SBICs with respect to (1) vintage year and (2) geographic location.

SBA's Early Stage SBIC Program

In 2012, SBA established a new type of SBIC that is required to invest at least 50 percent of its invested capital in "early stage companies." The Early Stage SBIC Program implements the "Start Up America Initiative," which was announced by the White House in January 2011 to foster American innovation and job creation by promoting high-growth entrepreneurship. An "early stage company" is one that has never achieved positive cash flow from operations in any fiscal year prior to investment by the SBIC. An Early Stage SBIC must be a limited partnership and have a minimum of $20 million of regulatory capital to be licensed. Regulatory capital is the sum of paid-in capital from private investors plus unfunded commitments from private investors that qualify as "institutional investors," as defined in SBA regulations (both entities and individuals may qualify as institutional investors). After being licensed, the Early Stage SBIC will be able to draw leverage from SBA in the form of 10-year debentures, with no required amortization. The amount of leverage that may be reserved for draws by an Early Stage SBIC will be limited to the lesser of the SBIC's regulatory capital or $50 million.

Interest on drawn debenture leverage is payable quarterly. An Early Stage SBIC must reserve the first five years of interest payments either by (1) having binding unfunded commitments in that amount from its institutional investors that can only be drawn to pay that interest or (2) maintaining that amount of cash in a separate bank or investment account. Alternatively, the Early Stage SBIC may draw discounted debentures from which the first five years of interest have been deducted from principal.

The total amount of leverage commitments that SBA will issue for the Early Stage SBIC program is limited to $1 billion. No more than $150 million of leverage commitments may be reserved in 2012; no more than $200 million of leverage commitments may be reserved per year from 2013 to 2015; and no more than $250 million of leverage commitments may be reserved in 2016. If sufficient leverage commitments are not available in a particular year, the commitments will be apportioned by SBA "pro rata" among the licensed Early Stage SBICs.

A variety of regulations govern the investments and operations of SBICs. An SBIC may generally only invest in U.S. companies that are "small businesses." A "small business" is (1) a business that has a tangible net worth not in excess of $19.56 million and average net income, after federal income taxes for the preceding two completed fiscal years, not exceeding $6.5 million or (2) a business that meets an alternative size test for its industry, based on number of employees or annual receipts (the alternative test). An SBIC must also have 25 percent of its financings in "smaller enterprises," which are (1) companies with net worths of no more than $6 million and average net incomes, after federal income taxes for the preceding two completed fiscal years, of no more than $2 million or (2) companies that meet the alternative test. An Early Stage SBIC may not reduce its regulatory capital without SBA's consent and must obtain SBA approval to incur third-party debt (even if unsecured), other than accounts payable from routine business operations. Distributions by an Early Stage SBIC may not be made to investors unless all payments on outstanding debenture leverage are current, and, depending on certain ratios, distributions may require a simultaneous repayment to SBA of outstanding leverage. SBA has a series of graduated remedies for failure to comply with its regulations.

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