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# Amendments and Clarifications to the Small Business Investment Company Investment Diversification and Growth Rules

## WRITTEN BY

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On January 19, the U.S. Small Business Administration (SBA) published a direct and final rule (the rule), including substantive and technical amendments and clarifications to the Small Business Investment Company Investment Diversification and Growth Rule implemented on August 17, 2023 (SBIC IDG Final Rule). The SBIC IDG Final Rule was passed in an effort to reduce barriers to program participation for new small business investment company (SBIC) fund managers investing in underserved communities and to modernize the program's license offerings. This alert provides a summary description of the material changes as a result of the rule, and considerations for SBICs. The rule will go into effect on March 4, without further action, unless significant comment is received by February 18. In the event that significant adverse comments are received, SBA will publish a timely withdrawal of the rule in the Federal Register.

## Reinvestor SBIC Affiliation

Following the SBIC IDG Final Rule, a new type of SBIC was established, known as a Reinvestor SBIC. A Reinvestor SBIC is based on a fund-of-funds model, investing in underlying funds with an underserved focus that, in turn, invests directly into small businesses and startups. The emergence of the Reinvestor SBIC has raised questions as to the applicability of the SBA affiliation rules to the relationship between such underlying fund and the qualifying small businesses in which the underlying fund invests. The rule added an exception to the SBA affiliation rules to exclude an underlying fund of a Reinvestor SBIC as an affiliate. Thus, the underlying fund of a Reinvestor SBIC is not considered an affiliate of a small business in which the underlying fund has made an equity investment.

## Maximum Amount of Leverage for Accrual SBICs and Reinvestor SBICs

SBA previously stated in the SBIC IDG Final Rule that SBA will determine the maximum leverage available to Accrual SBICs and Reinvestor SBICs by aggregating the total principal leverage plus 10 years of accrued interest on such principal. The rule clarifies and emphasizes that in conditionally approving an applicant's total intended leverage commitment to be included in the Green Light approval, SBA is performing a "forecasting exercise." As such, SBA notes that the aggregation to determine the maximum leverage available to licensees is based on an estimate of the potential interest, which could accrue based on interest rates at the time of licensing. In addition, licensees issuing Accrual Debentures should note that SBA will manage its risk of an outsized interest balance by requiring a provision in the licensee's Partnership Agreement (or other governing agreement) to promptly pay, at

the end of each quarter, any interest that has accrued in excess of the limitation of SBA leverage available to the licensee.

## **Timing for Payment by Accrual SBICs and Reinvestor SBICs of Accrued Interest and Annual Charges and Paydown of Leverage Principal Amounts**

Under the SBIC IDG Final Rule, prior to making a nontax distribution, Accrual SBICs and Reinvestor SBICs were required to pay any annual charges and all accrued interest on outstanding leverage at the next available payment window during which the Accrual SBIC or Reinvestor SBIC could pay leverage, but no later than six months following the nontax distribution to the SBIC's private investors. The SBIC IDG Final Rule also required Accrual SBICs and Reinvestor SBICs to pay down outstanding leverage within six months following a distribution to the SBIC's private investors based upon "SBA's share." The rule corrected and clarified the payment timing outlined in 13 CFR 107.585 for payments of annual charges and accrued interest and pay downs of outstanding leverage by Accrual SBICs and Reinvestor SBICs. The rule provides that if an Accrual SBIC or Reinvestor SBIC wants to make a nontax distribution to its investors, it is first required to pay all then accrued interest and annual charges and to pay down outstanding leverage based upon "SBA's share" prior to making any nontax distribution.

## **Investments by Government Entities in SBICs**

Previously, an SBIC could not accept capital commitments from local, state, or federal government entities in excess of 33% of an SBIC's Regulatory Capital.<sup>[1]</sup> The rule added 13 CFR 107.230(f) to provide that SBICs can accept *more* than 33% of their capital from local, state, or federal government entities; however, the invested capital from such local, state, or federal government entities in excess of 33% of an SBIC's Regulatory Capital cannot be leveraged, as it is limited by the Small Business Investment Act of 1958, as amended (SBIC Act). Therefore, there is no longer a cap on the aggregate capital commitments that an SBIC may accept from local, state, or federal government entities. Notwithstanding the limitation on leverage, the total capital contributed by the local, state, or federal government entities can be included in an SBIC applicant's formula to calculate management fees.

## **"Overline" Limitation Alignment**

The "overline" limit is a restriction on the amount that an SBIC is permitted to invest in any one company or its affiliates. Under the SBIC Act, the overline limit is 10% of the sum of (i) an SBIC's private capital, plus (ii) the total amount of leverage projected by the SBIC's business plan that was approved by SBA. In prior regulations, the overline limit was different from the statutory requirements. Prior regulations based the overline limit on 30% of an SBIC's Regulatory Capital for SBICs approved of two tiers of leverage, 25% of an SBIC's Regulatory Capital for SBICs approved of 1.5 tiers of leverage, and 20% of an SBIC's Regulatory Capital for SBICs approved of one tier of leverage. Depending on the amount of Regulatory Capital in an SBIC and an SBIC's business plan approved by SBA, there may have been discrepancies in the calculation for the overline limitation for the statutory overline limitation formula versus the regulatory overline limitation formula. For example, if a leveraged SBIC raised over \$87.5 million in Regulatory Capital and was approved for two tiers of leverage, the overline limit as calculated by the regulations would exceed the overline limit as calculated by the statutory requirements. Now, as a result of the rule, the statutory and regulatory calculations are aligned, and no such difference exists in calculation regardless of the amount of Regulatory Capital raised or tiers of leverage approved in the SBIC's business plan. Through this

alignment, SBA simplifies overline management for SBICs and eradicates the burden of tracking overline requirements under two separate regimes.

### **Subsequent SBIC Fund Investors**

Under the SBIC IDG Final Rule, a subsequent SBIC fund was eligible to apply for licensure under an “Expedited Subsequent Fund” evaluation process if, among other things, the two largest investors in terms of committed capital had verbally committed to investing in the new SBIC fund.<sup>[2]</sup> The rule replaced the two largest investor requirement with an expectation that a meaningful proportion of a prior SBIC fund’s Institutional Investor base would return to support the anticipated subsequent fund. Therefore, a subsequent SBIC fund applying for licensure seeking the “Expedited Subsequent Fund” evaluation process must ensure that a meaningful number of the Institutional Investors of its prior SBIC fund will invest in the anticipated subsequent SBIC fund.<sup>[3]</sup>

### **Qualification for a Fund of Funds as an “Institutional Investor”**

The rule revised the definition of an “Institutional Investor”<sup>[4]</sup> to include entities that are managed by an SEC-regulated registered investment adviser (RIA) in good standing and have a net worth (exclusive of unfunded commitments from investors) of at least \$1 million, provided that the licensee’s Partnership Agreement (or other governing agreement) contains sufficient provisions to ensure the collectability of any such entity’s capital commitment. Under prior regulations, such entities did not meet the definition of an “Institutional Investor,” and for their unfunded capital commitments to count toward an SBIC’s Regulatory Capital, the SBIC’s manager needed to arrange for a “dual commitment”<sup>[5]</sup> for such entity, heightening the burden on SBIC managers. The revised “Institutional Investor” definition generally provides flexibility and reduces the regulatory burden for an SBIC obtaining capital commitments from fund-of-funds investors managed by an RIA.

### **Due Dates for Form 468s Filed by Reinvestor SBICs**

The rule creates an exception for Reinvestor SBICs to file an annual Form 468 within 120 calendar days following the end of each fiscal year and quarterly Form 468s within 120 calendar days following the end of each quarter, instead of the general requirement for SBICs to file such forms within 90 calendar days and 45 calendar days following the end of such reporting periods, respectively.<sup>[6]</sup>

### **Expansion on the Ability for SBICs Owned by Business Development Companies to Use Blocker Entities**

The rule also adds an exception to permit an SBIC (with the intent for the SBIC to be one that is subsidiary of a business development company (BDC) licensed under the Investment Company Act of 1940 or owned by a parent BDC) to form a blocker entity that elects to be treated as a corporation for federal income tax purposes to avoid adverse tax consequences for an investor that has elected to be taxed as a registered investment company under the Internal Revenue Code.<sup>[7]</sup>

### **Investments in Community Development Financial Institutions and Minority Deposit Institutions by Reinvestor SBICs**

The SBIC IDG Final Rule enabled Reinvestor SBICs to invest in relenders or reinvestors, which are prohibited

from receiving investments from other types of SBICs.<sup>[8]</sup> The rule clarifies an additional intent of the exception to confirm that Reinvestor SBIC licensees may provide equity capital investments<sup>[9]</sup> to disadvantaged businesses<sup>[10]</sup> that are relenders or reinvestors, including community development financial institutions (CDFIs) and minority deposit institutions (MDIs) and such CDFIs and MDIs are not required to make direct financings to solely to small businesses. The rule also clarified that, in addition to equity capital investments, Reinvestor SBIC licensees may provide long-term debt or loan financing to CDFIs and MDIs.

## **Nonprofits Exempt From Management Ownership Diversity Requirement**

There is a general limitation under the SBIC Act that no person or group of affiliated persons may own or control, directly or indirectly, more than 70% of an SBIC's Regulatory or Leverageable Capital.<sup>[11]</sup> The sole exception to this management ownership diversity requirement was for traditional investment companies.<sup>[12]</sup> On October 19, 2022, SBA published proposed rules and regulations which, among them, proposed to add an exception to the management ownership diversity requirement for nonprofit entities. Although the final rulemaking stated that nonprofit entities could own and control SBIC licensees, the proposed rule was not formally adopted. The rule clarifies that nonprofit entities may own and control more than 70% of an SBIC's Regulatory Capital and Leverageable Capital.

## **Other Technical Corrections**

*Management Team Track Record:* The rule clarifies that while a track record is a required component of an SBIC license application, a "certified" track record that is audited by an independent certified public accountant is not required.

*Valuation Technical Error:* The rule corrects 13 CFR 107.503(d)(4) to state that an SBIC must report material adverse changes in valuations within 30 days and not 45 days following the close of a quarter. This correction aligns 13 CFR 107.503(d)(4) with the statutory requirements under the SBIC Act.

*General Eligibility Requirements for Leverage:* The rule corrects 13 CFR 107.1120(d), which erroneously stated that SBICs were limited to \$150 million in outstanding leverage. Following the correction, this section states that SBICs are permitted to have \$175 million in outstanding leverage.

*Clarification of Annual Charges:* The rule revises 13 CFR 107.1130(d) to clarify that the annual charge is to be paid on the outstanding principal amount of the licensee's debentures and is not inclusive of interest accrued.

*Watchlist Technical Correction:* The rule corrects the leverage coverage ratio set forth in 13 CFR 107.1850(a) to align with the formula for the leverage coverage ratio set forth in Form 468 and the SBA's standard operating procedures for the SBIC program. The leverage coverage ratio is calculated as follows: ((total assets *minus* liabilities excluding SBA leverage *minus* other assets) *plus* unfunded private commitments) *divided by* outstanding leverage.

## **For additional information, contact:**

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[1] "Regulatory Capital" is defined in 13 CFR 107.50.

[2] 13 CFR 107.305(e)(iii).

[3] Please note that this is one prong of 11 that must be satisfied to be eligible for the "Expedited Subsequent Fund" evaluation process. See 13 CFR 107.305(e) for the requirements.

[4] "Institutional Investor" is defined in 13 CFR 107.50.

[5] In general, a "dual commitment" is an arrangement in which a prospective investor that does not meet the definition of an "Institutional Investor" has his, her or its capital commitment "backed-up" by an individual and/or entity that meets the "Institutional Investor" definition.

[6] The instructions to Form 468, however, still provide that Reinvestor SBICs must submit a separate appendix within 90 calendar days after the end of each quarter. We expect SBA to clarify the due date for such appendix by releasing updated instructions to Form 468.

[7] 13 CFR 107.720(b)(3).

[8] 13 CFR 107.720(a).

[9] "Equity Capital Investments" is defined in 13 CFR 107.50.

[10] "Disadvantaged Businesses" is defined in 13 CFR 107.50.

[11] 13 CFR 107.150. "Leverageable Capital" is defined in 13 CFR 107.50.

[12] "Traditional Investment Companies" is defined in 13 CFR 107.150(b)(2).

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- [Small Business Investment Company \(SBIC\)](#)