

# Description of the Small Business Investment Company Debenture Program — Updated October 2023

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### The SBIC Program

A Small Business Investment Company (SBIC) is a privately owned and operated company that makes long-term investments in American small businesses and is licensed by the U.S. Small Business Administration (SBA or Administration).

The principal reason for a firm to become licensed as an SBIC is access to financing (leverage) provided by SBA. In addition, banks and federal savings associations (as well as their holding companies) have the ability to own or to invest in SBICs and thereby to own indirectly more than 5% of the voting stock of a small business, and can receive Community Reinvestment Act credit consideration for SBIC investments. Banks and their holding companies are permitted to invest in SBICs under the regulations implementing the Volcker Rule pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). A business seeking a U.S. government contract that is set aside for small businesses does not lose its status as a small business by reason of a control investment by an SBIC. Many business development companies (BDCs) also have formed SBIC subsidiaries as part of their business strategies.

This document provides a summary description of the SBIC Debenture Program, SBA leverage in the form of debentures, and a general overview of SBA regulations and policies applicable to debenture SBICs.

### The U.S. Small Business Administration

SBA administers the SBIC Program through its Investment Division. SBA is an independent federal agency at 409 Third Street, SW, Washington, DC 20006, (202.205.6510). Useful information about the SBIC Program is available on SBA's website at <https://www.sba.gov/partners/sbics/apply-be-sbic>.

### SBIA

The SBIC industry is served by an active trade association, the Small Business Investor Alliance (SBIA), which is located at 529 14th Street, NW, Suite 400, Washington, DC 20045, (202.628.5055) or at [www.sbia.org](http://www.sbia.org). SBIA, whose president is Brett Palmer, provides a variety of information and services to its members and represents the industry with SBA and on Capitol Hill. SBIA publishes regular updates and is a resource for information concerning

the SBIC Program.

## **Development of SBIC Program**

Established by the U.S. Congress in 1958 to stimulate long-term investment in American small businesses, the SBIC Program has evolved into a significant factor in financing smaller American businesses. SBICs have provided approximately \$123.8 billion of funding in approximately 192,286 financings to businesses since the SBIC Program's inception, of which \$7.8 billion was provided in approximately 3,182 financings during calendar year 2022.<sup>[1]</sup> Companies that have benefited from SBIC funding include well-known companies, such as Amgen, Apple Computer, Costco, Federal Express, Intel, Tesla, Amgen, Staples and Whole Foods.<sup>[2]</sup>

The SBIC Program has undergone significant changes since its creation in 1958. The original program permitted only debenture leverage. The Small Business Equity Enhancement Act of 1992 drastically changed the SBIC Program. It created a new form of SBA leverage known as "Participating Securities" (essentially preferred limited partnership interests in an SBIC); increased the amount of leverage available to an SBIC to \$90 million (which subsequently was indexed to reflect changes in the cost of living since March 31, 1993 and then modified in 2009 to be \$150 million and again in 2018 to be \$175 million); required minimum private capital of \$10 million for SBICs using Participating Securities and \$5 million for SBICs using debentures; provided for stricter SBA licensing standards; and enacted other changes to make the program more consistent with the private venture capital industry.

Unlike the Debenture Program (where SBA is a creditor of the SBIC) that requires an SBIC to make periodic interest payments, the Participating Securities Program required an SBIC to pay SBA a prioritized payment (preferred return) and a profit share when the SBIC realized profits. As a result, the Participating Securities Program was designed to permit investing in equity securities whether or not those securities had a current pay component. This new program resulted in a large expansion of the number of SBIC licenses granted.

Following the burst of the "technology bubble" in 2002, the Administration decided there no longer was a need for an equity SBIC program and that the existing Participating Securities Program would cause significant losses to SBA. Accordingly, SBA decided to terminate the Participating Securities Program and announced that beginning on October 1, 2004, it would not issue commitments to use participating securities leverage or license new SBICs using that leverage.

SBA officials continue to emphasize that they believe the Debenture Program is working well, and they want to expand it. The governing law and regulations for the Debenture Program have undergone several revisions since 1994 that have further streamlined and improved the SBIC Program. SBA has continued its outreach to institutional investors, bank regulators, and prospective applicants in order to enlarge the existing Debenture Program and to create ways for SBICs to make certain kinds of equity investments without undermining the program's financial integrity.

## **SBA's 2023 Investment Diversification and Growth Rule**

In furtherance of these efforts, SBA published the [Small Business Investment Company Investment Diversification and Growth Rule](#). This rule became effective on August 17, 2023 and represents the most significant changes to

the SBIC program since the early 1990s. The rule seeks to, among other things:

- reduce barriers to program participation for new SBIC fund managers and funds investing in:
  - underserved communities and geographies,
  - capital intensive investments, and
  - technologies critical to national security and economic development;
- increase program investment diversification and patient capital financing for small businesses; and
- modernize rules to lower financial barriers to program participation.

One major change is the creation of a new type of debenture and SBIC – the “Accrual Debenture,” which is designed to align with the cash flows of long-term, equity-oriented funds licensed as “Accrual SBICs.” The other major change creates a new type of SBIC – the “Reinvestor SBIC” – which is required to invest at least a majority of its capital in certain qualifying “reinvestors” (e.g., funds-of-funds).

### **Small Business Investment Company Critical Technologies Initiative**

In late 2022, the U.S. Department of Defense’s (DOD) new Office of Strategic Capital (OSC) and the SBA’s Office of Investment and Innovation (OII) launched a joint venture, the Small Business Investment Company Critical Technologies Initiative (SBICCT). The SBICCT is intended to encourage and scale early-stage investments in technologies that are critical to national security and traditionally have high, up-front research and development costs, such as semiconductors and biotechnology. The SBICCT is executed by SBA’s OII and DOD’s OSC by joining SBA’s expertise and experience executing the SBIC program with the DOD’s scientific and technical expertise and national security mission. By providing capital and technology sector guidance, the SBICCT aims to empower highly qualified investors to scale public-private partnered capital and catalyze investment in critical technology areas.

As a part of the SBIC license application process according to the SBICCT’s Investment Policy Statement, SBICCT applicants will be required to demonstrate a strategic intent to invest at least 60% of its aggregate financings (combined capital invested in small businesses) in portfolio companies directly involved in the development of one or more of the critical technology areas designated by DOD. DOD has currently prioritized 14 critical technology areas vital to maintaining U.S. national and economic security: biotechnology, quantum science, future generation wireless technology, advanced materials, trusted artificial intelligence and autonomy, integrated network systems-of-systems, microelectronics, space technology, renewable energy generation and storage, advanced computing and software, human-machine interfaces, directed energy weapons, hypersonics and integrated sensing, and cyber.

Many technologies the DOD and SBA view as critical to U.S. national security require heavy investment in research and development. The companies developing these technologies were unlikely to appeal to SBICs issuing standard debentures because SBICs would commonly view the terms of the SBIC standard debenture, with interest due and payable semiannually, as unattractive given their business models and expected cash flows. It is anticipated that the Accrual Debenture will attract growth equity and venture capital funds, which would, in turn, make patient long-term equity investments in these companies.

### **Program Statistics**

As of June 30, 2023,<sup>[3]</sup> there were 312 licensed SBICs with approximately \$23.34 billion of private capital and \$113.451 billion of outstanding SBA leverage (of which \$13.427 billion is debenture leverage and \$24 million is other SBA leverage — none of which is participating securities leverage). Of these SBICs: 251 use debentures; three used participating securities; 52 do not use leverage; and six are specialized SBICs.

During the 2022 federal fiscal year,<sup>[4]</sup> SBA licensed a total of 29 SBICs (four for first-time SBICs and 25 for subsequent fund SBICs) with approximately \$2.053 billion of private capital. Of those, 24 were debenture SBICs and five were unleveraged SBICs (*i.e.*, an SBIC that does not utilize SBA debenture leverage).<sup>[5]</sup> Through June 30 of the Federal FY 2023, SBA Licensed 22 SBICs (four for first-time SBICs and 18 for subsequent fund SBICs). Of these 22 SBICs, 19 were debenture SBICs and three were unleveraged SBICs.

## **SBA Leverage**

SBA currently provides financing (called leverage) to SBICs in the form of debentures. SBICs borrow leverage by issuing debentures, which are unsecured 10-year loans issued by the SBIC. There are two types of debentures — “standard” debentures and “Accrual Debentures.”

*Standard Debentures.* The principal amount of standard debentures is due in a single payment at its 10-year maturity date. Interest on standard debentures is payable semi-annually. Standard debentures bear a temporary interest rate until they are pooled and sold to the public in the form of trust certificates. The interest rate (excluding the annual SBA charge described below) on these debentures is fixed when SBA pools them from various SBICs and sells them to the public, with the pooled debentures having a 10-year maturity from the sale date. The interest rate recently has been between 2.8 and 160 basis points in excess of the interest rate on Treasury notes with 10-year maturities (Treasury Note Rate). In the most recent September 2023 debenture pooling of approximately \$1.546 billion, the interest rate was 5.688% (excluding the annual SBA charge described below). This interest rate represented a 140 basis point premium to the Treasury Note Rate and reflected an increase from the 5.168% rate (excluding the annual SBA charge described below) set in the March 2023 pooling and the second time the rate was set above 5% (the first being the March 2023 pooling) since the September 2008 pooling 15 years ago, which was set at 5.725%. As of June 30, 2023, there were \$13.427 billion of outstanding debentures, plus \$4.433 billion of undrawn commitments to issue debentures.

*Accrual Debentures* — Accrual Debentures are available to SBICs licensed as Accrual SBICs or Reinvestor SBICs. The principal amount of Accrual Debentures is due in a single payment at its 10-year maturity date. However, Accrual SBICs and Reinvestor SBICs are required to pay down all accrued and unpaid interest (and annual SBA charges described below) and a portion of the principal amount of their Accrual Debentures whenever the Accrual SBIC or Reinvestor SBIC makes a distribution (other than tax distributions permitted by SBA) to its private investors.<sup>[6]</sup> Unlike standard debentures, Accrual Debentures are not currently pooled. SBA indicated its intention to do so when sufficient supply exists to pool and sell Accrual Debenture trust certificates on the secondary market. In the meantime, SBA stated that it is working with a purchaser of Accrual Debentures who will hold them until maturity. SBA is also still developing the details for the funding and interest rate pricing of Accrual Debentures and stated that it will issue guidance as to these matters in the Fall of 2023.

## **LMI and Energy Saving Debentures**

More than a decade ago, SBA created LMI debentures for use by SBICs making equity investments in low and moderate income (LMI) zones or in companies with significant numbers of employees in LMI zones that are more fully described below under the heading LMI debentures. In addition, on April 19, 2012, SBA published final regulations authorizing a limited amount of so-called energy-saving debentures, which would enable SBICs licensed after 2008 to acquire equity securities in energy-saving qualified investments using debentures. To date, no energy-saving debentures have been issued.

## **Business Development Companies**

A significant number of the publicly traded BDCs have SBIC subsidiaries using debentures. A BDC-owned SBIC generally can use up to \$175 million of debentures on a 2:1 ratio to the amount of capital contributed to the SBIC. BDCs also may form more than one SBIC and thereby use up to \$350 million of debentures at one time. Formation of a second SBIC is subject to SBA policies that generally apply to the formation of subsequent SBICs. SBIC subsidiaries of BDCs, like other SBICs, are required to have a limited life, typically with a five-year investment period followed by a five-year harvest period, and they may not be formed with perpetual existence.

## **Reserving and Drawing Leverage**

SBICs obtain leverage by reserving a “leverage commitment” and then drawing down leverage from that commitment. Leverage commitments may be obtained at the time of licensing for an amount up to one tier<sup>[7]</sup> of leverage (subject to availability) and thereafter as needed (but not more than twice in any Federal FY) for an amount of up to two tiers of leverage in the case of a “standard” SBIC and a Reinvestor SBIC and up to 1.25 tiers of leverage for Accrual SBICs, in each case, subject to a statutory maximum of \$175 million per SBIC and \$350 million among SBICs under common control).<sup>[8]</sup> The actual amount of leverage that SBA will make available to Accrual SBICs and Reinvestor SBICs will be less than the foregoing number of tiers because, in determining the maximum amount of leverage for Accrual and Reinvestor SBICs, SBA will aggregate 10 years of forecasted accrued interest with the amount of leverage SBA will make available to the SBIC to ensure that the sum of such accrued and unpaid interest plus the amount of leverage made available to the SBIC will not exceed the maximum permitted amount of leverage.<sup>[9]</sup>

When a leverage commitment is issued, the SBIC pays a one-time commitment fee that is 1% of the amount of the commitment. A leverage commitment expires on September 30 of the fourth Federal FY following the Federal FY of its issuance.

SBICs issuing standard debentures may apply twice each month to draw down leverage commitments. SBA’s approval of a draw request is good for 58 days, and SBA can make a draw against the approval on one day’s notice. A newly licensed first-time SBIC is permitted to draw only “one-half tier” of leverage before SBA’s first regulatory examination (generally six to 10 months after licensure).

In March and September of each year, all standard debenture leverage issued by SBICs during the prior six-month period are pooled by SBA and sold to the public in the form of trust certificates, and the interest rate for all such leverage is established and fixed until it is repaid. Until they are pooled, debentures are funded to SBICs through an interim credit facility provided by the Federal Home Loan Bank of Chicago (FHLBC). At the time of each funding for these debentures, fees totaling 2.435% are deducted from the amount the SBIC receives (a 2% user

fee payable to SBA, 37.5 basis points of underwriting fees, one basis point as a trustee fee, and five basis points as an administrative fee to the selling agent). The SBIC pays an interim interest rate on debenture leverage equal to the FHLBC Fixed Regular Advance Rate (Bank Advance Rate), plus 41 basis points and the amount of SBA's charge described below.<sup>[10]</sup>

SBA expects to issue guidance for the drawing and funding of Accrual Debentures in the Fall of 2023.

### **Typical Use of Leverage**

A management team may hold a closing and form its fund at any time before or after it files an application for the fund to be licensed as an SBIC.<sup>[11]</sup> However, the fund may not make any investments or obtain leverage until it receives its license. In addition, SBA policies require that a newly licensed SBIC must invest at least 50% of the private capital that it had drawn in portfolio companies prior to the SBIC's receipt of leverage.<sup>[12]</sup> Some SBICs that have incurred sizeable organization expenses and/or management fees prior to making investments have found it necessary to draw more than \$2.5 million of private capital to comply with this policy. Thus, many SBICs draw their private capital to pay organization expenses and management fees and to make investments. Thereafter, these SBICs fund their operations solely by using SBA leverage until the ratio of outstanding leverage to paid-in capital from private investors (called leverageable capital) reaches the applicable leverage ratio. At that point, they generally coordinate capital calls from private investors with the use of leverage to maintain the applicable leverage-to-drawn private capital ratio.

### **Leverage Availability**

A single SBIC may use up to \$175 million of debentures, and the total amount of debentures that may be outstanding among a group of commonly controlled SBICs is limited to an aggregate of \$350 million. The amount of leverage commitments available to an SBIC is its regulatory capital multiplied by the tiers of leverage that SBA has approved for the SBIC.

SBA obtains funds enabling it to supply leverage for pooled standard debentures by guarantying payment of trust certificates purchased by traditional purchasers of government-guaranteed notes. SBA then invests the proceeds in SBICs in the form of standard debentures. SBA-guaranteed trust certificates for standard debentures are sold in March and September of each year. SBA obtains funds enabling it to supply leverage for LMI debentures and certain other debentures by guarantying loans made by the FHLBC. As previously described, SBA is working with a purchaser of Accrual Debentures to obtain funds necessary to enable it to supply leverage for Accrual Debentures and will issue guidance as to funding these matters in the Fall of 2023.

The amount of leverage commitments that may be issued each year is subject to the amount authorized by Congress. In recent years, Congress has enacted authorized levels in three-year cycles. Until FY 2021, leverage commitments issued each year by SBA have been well below the \$4.0 billion amount authorized by Congress. In FY 2021, SBA for the first time issued leverage commitments in the full \$4 billion amount authorized. For FY 2023, Congress authorized \$5 billion for leverage commitments. Although Congress has not yet fixed the authorization amount for FY 2024, there is presently a continuation of the FY 2023 \$5 billion authorization through mid-November pending the passage of appropriation bills.



During Federal FYs 2018–2022, SBA issued a total of \$14.120 billion of leverage commitments as shown in the following chart:

Federal FY	Leverage Commitments Issued by SBA
2018	\$2.522 billion
2019	\$1.614 billion
2020	\$2.102 billion
2021	\$4.000 billion
2022	\$3.882 billion

SBICs drew a total of \$11.633 billion of debenture leverage during the past five Federal FYs in the amounts shown in the following chart:

Federal FY	Leverage Drawn by SBICs
2018	\$2.119 billion
2019	\$1.927 billion
2020	\$1.796 billion
2021	\$2.442 billion
2022	\$3.349 billion

The trust certificates representing an interest in the pooled standard debentures are sold with the assistance of investment bankers (who receive a 37.5 basis point fee) to institutional purchasers of government-guaranteed, fixed-rate notes with 10-year maturities. The interest rate on trust certificates is a premium over the 10-year Treasury Note Rate. The premium has been as high as 2.273% in the September 2008 pooling. Since then, the premium has decreased dramatically and, during the last five years, has generally been less than 1% (with the March 2020, the March 2023, and September 2023 poolings being exceptions). The premium over the 10-year Treasury Note Rate for each of the last ten poolings is shown in the following chart:

Pooling Date	10-Year Treasury Rate	Premium	Total Interest Rate (excluding SBA Charge)
March 2019	2.600%	0.513%	3.113%
September 2019	1.822%	0.461%	2.283%
March 2020	0.743%	1.335%	2.078%
September 2020	0.677%	0.357%	1.034%
March 2021	1.614%	0.053%	1.667%
September 2021	1.276%	0.028%	1.304%
March 2022	2.138%	0.800%	2.938%
September 2022	3.412%	0.850%	4.262%
March 2023	3.568%	1.600%	5.168%
September 2023	4.288%	1.400%	5.688%

SBA is required by statute to set the amount of the charge it imposed on commitments issued each Federal FY at the rate necessary so that the sum of all fees charged (including 1% commitment fees, 2% user fees, the annual charge, and anticipated profit distributions) would equal the amount of anticipated losses on leverage issued. The charge for leverage commitments issued since 2001 varied from a low of 0.047% for the Federal FY 2023 to a high of 0.94% for Federal FY 2006. The charge for leverage commitments issued in Federal FYs 2019, 2020,

2021, 2022 and 2023 was 0.094%, 0.275%, 0.271%, 0.173%, and 0.047% respectively. The charge for leverage commitments issued during Federal FY 2024 is 0.129%.<sup>[13]</sup>

The annual charge is paid at the same time and on the same terms as interest is paid on debentures.

SBA's website contains historical information concerning the SBIC Program, including the amount and pricing of leverage committed and issued since the SBIC Program was restructured in 1994.

**Calculation Summary of Interest Rate Charged on Conventional Pooled Debentures**

The rate of interest payable by a conventional SBIC on pooled debentures is the sum of the following:

- 1. The interest rate of Treasury notes with 10-year maturities at the time the trust certificates are pooled and sold;
- 2. The premium required by the purchasers of the trust certificates above the 10-year Treasury Note Rate; and
- 3. The annual charge payable to SBA at the rate applicable in the Federal FY in which the commitment was issued.

For example, the interest rate for debentures issued in the September 2023 pooling pursuant to a leverage commitment issued during Federal FY 2022 was:

4.288%	10-year Treasury rate
<u>1.400%</u>	Premium required by trust certificate purchasers
<u>0.173%</u>	SBA charge for debenture commitment issued in Federal FY 2022
<u>5.861%</u>	<b>Total Interest Rate</b>

**Repayment of Debenture Leverage**

Debentures are unsecured, and the general partner of the SBIC is generally not liable for their repayment. Standard debentures that have 10-year maturities from the date of pooling are not amortized prior to maturity, and bear interest payable semi-annually. Accrual Debentures have 10-year maturities, are not amortized prior to maturity, and accrue interest but do not require periodic scheduled interest payments. However, all accrued and unpaid interest and annual charges and a portion of the principal amount of Accrual Debentures are required to be repaid whenever an Accrual SBIC or Reinvestor SBIC makes a distribution (other than tax distributions permitted by SBA) to its private investors.<sup>[14]</sup>

Beginning with the September 2006 issuance, debentures may be prepaid without penalty, but a debenture must be repaid in whole. Repayment of debentures is subordinate to repayment of loans from non-associate lenders up to the lesser of \$10 million or twice the amount of the SBIC's regulatory capital.

**Unrelated Business Taxable Income Exemption**

Tax-exempt entities that invest in SBICs licensed since 2004 will not recognize unrelated business taxable income (UBTI) as a result of the issuance of debentures if (1) no tax-exempt investor (other than a governmental unit) owns more than 25% of the capital or profits interest of the SBIC, and (2) all tax-exempt investors (including



governmental units, other than any U.S. agency or instrumentality) own less than 50% of the capital and profits interest of the SBIC.

### **Distributions by Debenture SBICs**

All SBICs Generally. All SBICs using debentures (including Accrual SBICs and Reinvestor SBICs) make distributions to their partners as provided in the SBIC's limited partnership agreement. However, the sources of those distributions are limited as follows:

1. Distributions from positive "retained earnings available for distribution" (READ). READ consists of an SBIC's cumulative realized profits after all expenses and all realized and unrealized losses and write-downs have been deducted. When making a determination as to whether (or the extent to which) the SBIC has READ, the SBIC is required to consider any adverse changes to its portfolio to see if any write-down or write-off of any investment is warranted.
2. In addition to distributions from READ described in paragraph 1 above, except as provided in paragraph 3 below, until all debentures have been repaid in full, an SBIC may make distributions in any calendar year up to 2% of its regulatory capital.<sup>[15]</sup>
3. After an SBIC has substantially completed making new investments, it generally files a "wind-down" plan with SBA. If SBA feels secure about repayment of outstanding debentures, SBA may permit some repayment of regulatory capital prior to the repayment in full of all outstanding debentures. SBA generally only gives that approval when the SBIC has previously made significant repayments of debentures, the remaining portfolio is performing well, and SBA feels reasonably well assured that outstanding debentures will be repaid in full. Regarding funds available for distribution, an SBIC will seek to negotiate with SBA the proportion of those funds that will be used to repay debentures and to make distributions constituting a return of regulatory capital. While at times this proportion is 1:1, an SBIC cannot reliably predict what arrangement, if any, SBA may be willing to accept.

SBICs are permitted to make distributions before the end of a fiscal year. In situations where an SBIC made a distribution mid-year from READ that then existed, but at the end of the year the SBIC did not have READ for the year (e.g., if the SBIC wrote off an investment after mid-year), SBA has taken the position that the SBIC's distribution was improper, and that event of default occurred under the debenture leverage. In this instance, the SBIC would be given a specified period of time to cure the default, at least 15 days. Failure to do so could result in SBA declaring all debentures immediately due and payable, and seeking the appointment of SBA or its designee as a receiver.

Standard Debentures – Leveraged SBICs using standard debentures are permitted to make distributions without making any repayment of its debentures.

Accrual SBICs and Reinvestor SBICs – Because equity-oriented funds present a risk to SBA that such funds may distribute early profit returns and then later write down or write off assets without repaying SBA leverage by the end of the fund's life, SBA has implemented a different distribution regime for Accrual SBICs and Reinvestor SBICs to provide protection to SBA and taxpayers against such risk. Except for tax distributions that have been approved by SBA, if an Accrual SBIC or Reinvestor SBIC wants to make a distribution to its investors, it is first required to pay to SBA all then accrued and unpaid interest and annual charges on the outstanding leverage and, from the remaining amount, pay down a portion of the principal of its outstanding Accrual Debentures at the next payment window during which SBICs can pay leverage. The principal amount required to be repaid to SBA (the "SBA Share") is based upon the proportion that the maximum amount of leverage SBA will make available to the

Accrual SBIC or Reinvestor SBIC (referred to in the SBA regulations as the “Total Intended Leverage Commitment”) bears to the sum of the Total Intended Leverage Commitment, plus the total private capital commitments made to the Accrual SBIC or Reinvestor SBIC. Thus, for example, if the Total Intended Leverage Commitment is \$125, the total private capital commitments are \$100, the outstanding Accrual Debenture principal is \$75, and the amount available for distribution (after paying all accrued and unpaid interest and annual charges) is \$100, the Accrual SBIC or Reinvestor SBIC would pay \$55.56 ( $\$100 \times \{\$125/[\$125+\$100]\} = \$55.56$ ) to SBA and distribute \$44.44 to its investors.

## **Just in Time Financing**

The SBIC Program permits the funds from investors and SBA leverage to be taken down by the SBIC in lock step, thereby delaying investor capital calls and potentially increasing investor returns. However, SBA requires an SBIC applicant to have firm commitments when it files its formal license application in an amount equal to the amount of capital that is sufficient to enable the applicant to have a first closing and conduct its operations even if does not subsequently raise additional funds (generally, at least \$20-\$25 million). While an applicant needs to have binding subscriptions for the full amount of its regulatory capital, only \$2.5 million of the SBIC’s regulatory capital needs to be paid-in prior to issuance of the SBIC license.<sup>[16]</sup>

## **LMI Debentures**

SBA regulations provide incentives for SBICs to invest in low and moderate income (LMI) zones. An LMI zone is a geographic area that satisfies one of five definitions that currently are used by different federal agencies in determining areas requiring special attention. Debenture SBICs also may use LMI debentures. Highlights of the regulations are as follows:

1. SBICs making venture capital type investments (equity or certain subordinated loans) in small businesses with 50% or more of its employees or tangible assets in an LMI zone, or to a small business that has 35% of its employees residing in an LMI zone, are eligible to obtain SBA financing in the form of a deferred interest debenture. These LMI debentures are non-amortizing debentures with maturities of five or 10 years, each with a “zero coupon” for the first five years. This means, *g.*, if the interest rate is 5%, the SBIC would receive approximately \$75,000 in proceeds for issuing a \$100,000 debenture. On the 10-year debentures, interest would be payable semi-annually commencing in the sixth year.
2. The small business financed by the SBIC must either satisfy the employee or asset test described above at the time of applying to the SBIC for financing, or within 180 days after the closing of the financing.
3. LMI debentures will be issuable to SBICs that have reserved debenture leverage. At the time of making a draw request, the SBIC specifies whether it will use an LMI debenture or a regular debenture. The interest rate for the LMI debenture is fixed when it is initially issued for its full term. LMI debentures will be held by the Federal Home Loan Bank of Chicago and are not pooled in the same manner as other leverage.

## **Community Reinvestment Act Credit**

Current Community Reinvestment Act (CRA) regulations present banks (other than certain small banks) with a continuing need to make investments that qualify for CRA purposes. Investment in an SBIC is specifically identified in the CRA regulations as a type of investment that will be presumed by the regulatory agencies to be a qualified investment for CRA purposes.<sup>[17]</sup> The investment should be in an SBIC that is located in or doing substantial business in the region in which the bank’s assessment area is located, but the SBIC is not required to

be headquartered within the assessment area itself. The SBIC Act and other federal statutes explicitly permit banks, bank holding companies, federal savings associations, and savings and loan holding companies to invest in SBICs.

### **Bank Risk-Based Capital Requirements and Dodd-Frank Act Exemptions**

Depending on their size, banks are subject to minimum risk-based capital requirements as calculated under either the standardized risk-based capital rules or the advanced measurement approaches.<sup>[18]</sup> Under the standardized risk-based capital rules, SBIC investments in the form of equity are assigned a capital charge using the simple risk-weight approach (SRWA) for equity exposures. When SBIC equity exposures, in the aggregate, are under 10% of total risk-based capital, a 100% risk weight is assigned (which is considered a non-significant equity exposure). When SBIC equity exposures, combined with any other equity exposures of the bank, are equal to or greater than 10% of total capital, the equity exposure amount up to 10% of total capital receives a 100% risk weight, and the remaining amount of equity exposure receives a 300% or 400% risk weight, depending on whether or not the equity exposure is a publicly traded equity.

Advanced approaches banks may also use the SRWA for equity exposures. In addition, subject to prior written approval by the bank's primary federal regulator, an advanced approaches institution may calculate the risk-weighted asset amount for SBIC equity exposures using the internal models approach. Additionally, a zero percent risk weight may be assigned to the carrying value of the guaranteed portion of held-for-sale SBA Guaranteed Interest Certificates purchased in the secondary market. Generally, a 20% risk weight is assigned to the carrying value of the guaranteed portion of an SBA loan originated and held by the reporting bank.

The Dodd-Frank Act generally prohibits a banking entity from acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a private equity fund. In addition, nonbank financial companies that engage in proprietary trading, ownership, or sponsorship of a private equity fund may be subject to additional capital and quantitative limits. These prohibitions are not applicable to investments in SBICs. The final regulations implementing the Volcker Rule under the Dodd-Frank Act permit banking entities to invest in licensed SBICs, as well as in funds that have received permission from SBA to file an SBIC license application, and to sponsor SBICs. Effective October 1, 2020, the Volcker Rule was revised to clarify that banking entities are permitted to retain their investments in a private fund that ceases to be licensed as an SBIC because it has voluntarily surrendered its license so long as the fund does not make any new investments (other than in cash and cash equivalents) after such voluntary surrender.

### **Investment Advisers Act Exemption**

An adviser that solely advises SBICs (which, for this purpose, also includes an entity that has received a green light letter authorizing it to submit a formal SBIC license application to SBA, as well as an applicant affiliated with one or more SBICs that has applied for another SBIC license) is expressly exempted from the Dodd-Frank Act amendments to the Investment Advisers Act of 1940 (Advisers Act), which generally require advisers to certain types of private funds to register with the Securities and Exchange Commission (SEC) or to become exempt reporting advisers.

The SBIC Advisers Relief Act, which became law on December 4, 2015, provides certain additional relief for

investment advisers that advise private funds and SBICs, as well as for investment advisers that advise venture funds and SBICs. Before the enactment of the SBIC Advisers Relief Act, only advisers solely to private funds with assets under management in the U.S. of less than \$150 million could rely upon the so-called “private fund adviser exemption” from the Advisers Act’s investment adviser registration requirements. Also, before the enactment of the SBIC Advisers Relief Act, only advisers solely to one or more venture capital funds (as defined by the SEC) could rely upon the so-called “venture capital fund adviser exemption” from the Advisers Act’s investment adviser registration requirements. The SBIC Advisers Relief Act revised the private fund adviser exemption by excluding SBIC assets from counting toward the \$150 million threshold for purposes of determining whether an investment adviser satisfied the conditions for the private fund adviser exemption and by deeming SBICs to be venture capital funds for purposes of the venture capital fund adviser exemption.

## **SBIC Investments**

An SBIC can only invest in small businesses and must invest at least 25% of its invested funds in smaller enterprises.<sup>[19]</sup> SBA regulations define a small business as a company with tangible net worth (total net worth less goodwill) of less than \$24 million and average after-tax income (exclusive of loss carryforwards) for the prior two years of less than \$8.0 million. A company failing that test can still qualify as a small business if it meets the size standards for its industry group under an alternative test. The size standards for industry groups under this alternative test are based on the number of employees (typically 500 to 1,000 for a manufacturing company) or gross revenues.<sup>[20]</sup> A smaller enterprise is a company with a net worth of less than \$6 million and average after-tax income for the prior two years of less than \$2 million or one that meets the alternative test. Most importantly, in making a determination under the size test and the alternative test, the company and all affiliates of the company must be considered. Companies are affiliates of each other if one controls or has the power to control the other, or a third party or parties control or have the power to control both. SBICs and private funds exempted from registration under certain sections of the Investment Company Act of 1940 are not considered affiliates of a company for purposes of determining whether that company qualifies as a small business or a smaller enterprise. Certain debt-to-equity ratios must also be met if an SBIC finances the change of ownership of a small business with more than 500 employees.

SBIC regulations restrict the amount that an SBIC is permitted to invest in any company and its affiliates (the overline limit). Legislation enacted in 2009 changed the overline limit to 10% of the sum of regulatory capital<sup>[21]</sup> and the total amount of leverage projected to be used by the SBIC in its business plan that was approved at the time its SBIC license was granted (*i.e.*, 30% of regulatory capital if the capital is \$87.5 million or less and is proposed to be fully leveraged with two tiers of leverage). By way of example, if an SBIC has regulatory capital of \$25 million, it may not invest more than \$7.5 million in a single company without SBA’s approval (assuming the SBIC was approved for two tiers of leverage at the time it was licensed as an SBIC). SBA may approve a larger percentage if necessary to protect the SBIC’s investment, but has indicated it will give such consent only in unusual circumstances.

SBIC regulations preclude investment in the following types of businesses: companies whose principal business is re-lending or re-investing (venture capital firms, leasing companies, factors, banks) unless the SBIC is specifically licensed as a Reinvestor SBIC); various real estate projects; single-purpose projects that are not continuing businesses; companies that will use the proceeds outside of the U.S. or that have more than 49% of their tangible assets or employees outside the U.S. at the time of financing or within one year following the financing (unless the

funding is used for a specific U.S. purpose that is acceptable to SBA); businesses that are passive and do not carry on an active trade or business; and businesses that use 50% or more of the funds to buy goods or services from an associated supplier.

Reinvestor SBICs must invest at least a majority of their capital through equity investments made in “underserved” small business reinvestors (except banks, savings, and loans not insured by agencies of the federal government, and agricultural credit companies) who, in turn, make investments solely to small businesses (1) with at least 50% of employees in the U.S., (2) headquartered in the U.S., (3) owned and controlled by U.S. citizens and/or entities, and (4) that are eligible for investment based on SBA size standards. Reinvestor SBICs may invest in underlying funds which are non-leveraged SBICs and funds which do not hold an SBIC license, so long as they meet SBA size standards and are underserved. Reinvestor SBICs cannot invest in leveraged SBICs. SBA may also require that a Reinvestor SBIC obtain a written agreement from each reinvestor in which the Reinvestor SBIC invests that the reinvestor has only provided and will only provide financing in compliance with the foregoing and will provide to such Reinvestor SBIC information reasonably necessary to verify its compliance. Reinvestor SBICs are also permitted to make investments directly into small businesses. Although undefined, SBA notes that “underserved” is broad so that SBA can maintain flexibility and agility to align with evolving market conditions by clarifying what constitutes “underserved” through policy notices in order to increase its economic impact to underserved communities.

An SBIC and its associates<sup>[22]</sup> are permitted to control a small business for up to seven years. Upon request, SBA may allow for a longer period if doing so would permit an orderly sale of the investment or to ensure the financial stability of the small business.

SBICs are precluded from making investments in a small business if it would give rise to a conflict of interest. Generally, a conflict of interest may arise if an associate of the SBIC has or makes an investment in the small business or serves as one of its officers or directors or would otherwise benefit from the financing. Investing in an associate generally requires prior SBA approval unless an exception applies. Joint investing with an associate (such as another fund controlled by affiliates of the general partner) may be made on the same terms and conditions and at the same time or on terms that can be demonstrated to SBA's satisfaction that are fair and equitable to the SBIC.

### **Terms of Portfolio Company Financings**

An SBIC may make investments in the form of debt with no equity features (loans) debt with equity features (debt securities) or stock, rights to acquire stock, and interests in limited partnerships, limited liability companies, and joint ventures (equity securities). Investments must be made for a term of at least one year (except for bridge loans in anticipation of a permanent financing in which the SBIC intends to participate or to protect the SBIC's prior investment). Loans and debt securities must have amortization not exceeding the “straight line.” The permissible interest rate depends on the type of debt. For straight loans, the maximum permitted rate is the higher of (a) 19% or (b) 11% over the higher of the SBIC's weighted cost of debenture leverage or the current debenture rate. For debt securities, the maximum permitted rate is the higher of (i) 14% or (ii) 6% over the higher of the SBIC's weighted cost of debenture leverage or the current debenture rate. Regulations define an SBIC's weighted cost of debenture leverage and describe the maximum permitted rate when more than one SBIC participates in the financing.

The applicable interest rate is calculated adding in all points, fees, discounts, and other costs of money, other than (i) application fees of up to 1% of the proposed financing and closing fees of up to 4% of the financing for equity securities or debt securities, or 2% for loans and permitted prepayment penalties, each of which may be charged in addition to the permitted interest. In addition, an SBIC may be reimbursed for its reasonable closing costs (including legal fees). SBICs may also structure financings to receive a royalty based upon the improvement in the performance of a portfolio company after the financing. An SBIC may also charge a default rate of interest of up to 7% and a royalty based on improvement in the performance of a portfolio company after the financing.

An SBIC is permitted to require a small business to redeem equity securities, but only after one year and only for a price equal to either (a) the purchase price or (b) a price determined at the time of redemption based on (i) a reasonable formula that reflects the performance of the company (e.g., based on the book value or earnings) or (ii) fair market value determined by a professional, third-party appraiser. Mandatory redemptions not complying with these requirements will result in the investment being treated as a debt security, subject to the maximum interest restrictions described above. However, the small business can be required to redeem the SBIC's equity security earlier than one year after its issuance if the small business has a public offering, has a change of control or management, or defaults under its investment agreement.

An SBIC is permitted to retain its investment in a business that ceases to be a small business and is permitted to continue to invest in such a large business until the company has a public offering. Following a public offering, the SBIC is permitted to exercise rights to acquire securities that were obtained prior to the public offering.

If within one year of the initial financing by an SBIC a portfolio company changes its business to one in which an SBIC is prohibited from investing, then the SBIC must divest itself of the investment absent SBA's approval to retain the investment.

## **SBIC Operations**

SBA has adopted new [standard operating procedures](#), effective September 5, 2023, detailing (among other matters) operating requirements of SBICs intended to assure their proper management. Principal regulations and policies are described below.

An SBIC using leverage must invest its idle funds not invested in small businesses in liquid, safe, short-term investments specified in the regulations: principally, U.S. government obligations; repurchase obligations with federally insured institutions with a maturity of seven days or less and whose underlying securities are direct U.S. government obligations; federally insured deposits; and deposits in well-capitalized, federally insured financial institutions.

An SBIC and its associates may provide management services to small businesses in which the SBIC invests, but may only charge competitive rates for services actually rendered. SBA requires that leveraged SBICs credit 100% of such fees (if not paid to the SBIC) against the management fee otherwise payable by the SBIC to the management team (except for placement fees paid to associated licensed broker-dealers).

SBICs are required to value their assets annually (quarterly, if leverage is used) pursuant to valuation guidelines approved by SBA. SBA has issued model valuation guidelines that are similar to those customarily used by



venture capital firms, but do not conform with generally accepted accounting principles.

An SBIC's ability to borrow funds from third parties is subject to SBA regulation. If an SBIC wants to incur secured debt, it can obtain, without SBA's written approval, a line of credit from a federally regulated financial institution that meets all of the following conditions ("Capital Call Line"):

- The maximum amount available under the Capital Call Line is no more than unfunded regulatory capital, as reflected on the SBIC's most recent Capital Certificate;
- The payment obligations under the Capital Call Line may be secured, but only by unfunded regulatory capital;
- The lender under the Capital Call Line may have a right to debit the SBIC's depository account(s) at the lender's institution, so long as such lender's right to debit is limited to circumstances involving a default of the SBIC's obligation to pay principal, interest, or fees due ("Payment Default") under the Capital Call Line and only to the amount of such Payment Default;
- Each borrowing under the Capital Call Line must be repaid, in full, within 120 days after it is drawn;
- The term of the Capital Call Line may not exceed 12 months, but may be renewable, provided that each renewal does not exceed 12 months and the SBIC remains in compliance with the other conditions of this paragraph; and
- The Capital Call Line does not contain any provision permitting the lender to dictate when capital calls are made or otherwise ceding to the lender any control of the SBIC or its operations; provided, however, that the Capital Call Line may include a provision authorizing the lender, in the event of a Payment Default, to endorse, on the SBIC's behalf, checks and other forms of payment in the lender's possession and to apply the proceeds of such instruments to such Payment Default, with unapplied and remaining proceeds promptly to be paid to the SBIC.

SBICs are required to file a variety of reports with SBA, none of which generally are considered burdensome. These reports include an annual financial statement certified to by the SBIC's independent certified public accountants (and contains information concerning each portfolio company), valuation reports as described above, capital certificates reporting, among other things, changes in regulatory capital and leverageable capital, reports as to changes in the SBIC's management, material litigation, a brief report describing each investment, and copies of reports sent to investors and, if applicable, to the SEC. SBA will conduct regulatory examinations of each SBIC on an annual basis.

A key regulatory metric for SBA is the extent of "capital impairment" — which is the extent of realized (and, in certain circumstances, net unrealized) losses of an SBIC compared with the SBIC's regulatory capital. Interest payments, management fees, organization, and other expenses are included in determining realized losses. SBA regulations preclude the full amount of unrealized appreciation in the value of an SBIC's portfolio investments from being considered when calculating capital impairment in certain circumstances. If an SBIC issues leverage, it will be required to avoid capital impairment. Capital impairment will be considered to exist if the SBIC's capital impairment ratio (calculated by adding the SBIC's realized losses and net unrealized depreciation<sup>[23]</sup> and dividing the result by the SBIC's private capital) exceeds permitted levels detailed in the regulations and which vary depending on the proportion of equity investments made by the SBIC and the ratio of outstanding leverage to leverageable capital.

SBA has certain rights and remedies if the SBIC violates SBA regulations, which include being in a condition of capital impairment. Remedies for regulatory violations are graduated in severity depending on the seriousness of capital impairment or other regulatory violation. For minor regulatory infractions, warnings are given. For serious

infractions the use of debentures may be limited or prohibited, outstanding debentures may be declared to be immediately due and payable, restrictions on distributions and making new investments may be imposed, management fees may be required to be reduced, and investors may be required to pay their unfunded capital commitments to the SBIC. In severe cases, SBA may require the limited partners to remove the SBIC's general partner or manager or its officers, directors, managers or partners, or SBA may obtain appointment of a receiver for the partnership.

## **Organization**

SBICs are organized under state law as corporations, limited partnerships, or limited liability companies. SBA strongly encourages debenture SBICs to be organized as limited partnerships.

## **Investors**

Investors may be either domestic or foreign<sup>[24]</sup> individuals or entities. The SBIC Act specifically authorizes banks and federal savings associations to invest up to 5% of their capital and surplus in SBICs.<sup>[25]</sup> Certain investors owning 33% or more of an SBIC are required to submit certain background information to SBA and are subject to SBA's fingerprinting requirements. All investors in an SBIC and anyone owning 10% or more of any investor owning 10% of an SBIC must be identified to SBA in the SBIC's license application.

## **Diversity of Ownership**

SBA has regulations and policies designed to assure that leveraged SBICs receive significant investments from investors not participating in or otherwise controlling the SBIC's management. Additionally, a leveraged SBIC must receive at least 30% of its private capital from a total of three or more investors unrelated to the management and not affiliated with one another or from a single such investor meeting certain limited qualifications (such as a bank, insurance company, or certain publicly traded corporations). No single investor, together with its affiliates, may own more than 70% of a leveraged SBIC's private capital.

## **Restrictions on Transfer**

Investors in an SBIC may not transfer their interests without SBA's prior consent. Additionally, as a condition to providing leverage to the SBIC, SBA presently requires investors owning 50% or more of an SBIC that uses leverage (as well as the SBIC's managers and other control persons) to enter into a written agreement with SBA providing for personal liability for repayment of leverage for directly or indirectly participating in a change of control of an SBIC without SBA's prior consent. Additionally, without SBA's consent, an SBIC may not release any of its investors from the liability to make the full amount of their capital contribution.

## **Management Fee**

Management fees paid by SBICs using leverage are subject to SBA's prior approval. Generally, an SBIC's management fee is determined by multiplying a "management fee base" by a "management fee percentage." During the SBIC's initial 5-year period, the management fee base consists of the sum of the SBIC's regulatory capital, plus its "assumed leverage" (*i.e.*, the maximum amount of SBA-guaranteed leverage that the SBIC may

apply for consistent with the SBIC's business plan approved by SBA). After this initial 5-year period, the management fee base consists of the SBIC's cost basis in its "active portfolio companies" (*i.e.*, a company that remains an ongoing concern and in which the SBIC's investment has not been written off or written down to zero). Absent special circumstances justifying a higher fee (which justification must be approved by SBA at the time of application), the management fee rate must not exceed 2%. However, the management fee rate which a Reinvestor SBIC may charge in respect of its underlying fund investments may not exceed 1%.

SBA requires that management fees for leveraged SBICs be reduced by 100% of consulting, board, and other fees received from portfolio companies by affiliates of the SBIC's general partner (except for fees paid to licensed broker-dealers). SBA only permits increases in regulatory capital to create a prospective entitlement to increased management fees (*i.e.*, the increased level of management fees only may be charged from the beginning of the calendar quarter in which the regulatory capital is increased, not the date of the initial closing).

Fund Sequence	Initial Licensing Fee
Fund I	\$5,000
Fund II	\$10,000
Fund III	\$15,000
Fund IV+	\$20,000

SBA generally requires that an SBIC have at least two substantially full-time principals with substantial professional experience supportive of the fund's proposed investment strategy and business plan. At least one of these principals must possess substantial relevant investing or long-term lending experience aligned to the investment strategy proposed by the applicant. Senior level industry operator experience, commercial banking, investment banking, private equity investor relations, and merger and acquisition experience may also be considered in SBA's evaluation of a management team's overall qualifications so long as it is relevant to, and supportive of, the fund's proposed investment strategy and business plan. Generally, investment experience must be evidenced by the individual's track record, which should include at least 10-15 investments with a reasonable number of complete realizations during the last 10 years (and preferably including some that are quite recent). SBA also considers how long and in what ways the management team has worked together. SBA views the track record of the principals and the cohesiveness of the key principals as being fundamentally important. Additionally, SBA is concerned about the internal management of the SBIC. They prefer a team composed of three to five principals, although as few as two and as many as six also are acceptable.

## RELATED INDUSTRIES + PRACTICES

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