

Description of the Small Business Investment Company Debenture Program — Updated September 2022

WRITTEN BY

Christopher A. Rossi

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). They also receive exemptions from certain capital charge regulations and lending affiliation rules under the Gramm-Leach-Bliley 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](#) or may be obtained by contacting Samuel J. Boyd, Jr. at 202.205.7546.

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. 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. From the SBIC Program's inception to December 31, 2021, SBICs have provided approximately \$116.0 billion of funding in approximately 189,101 financings to businesses,^[1] including well-known companies, such as Amgen, Apple Computer, Costco, Federal Express, Intel, Tesla, and Whole Foods.^[2]

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.

As of June 30, 2022,^[3] there were 299 licensed SBICs with approximately \$21.094 billion of private capital and \$11.866 billion of outstanding SBA leverage (of which \$11.840 billion is debenture leverage and \$26 million is other SBA leverage — none of which is participating securities leverage). Of these SBICs: 234 use debentures; four used participating securities; 55 do not use leverage; and six are specialized SBICs.

During the 2021 federal fiscal year,^[4] SBA licensed a total of 32 SBICs (12 for first-time SBICs and 20 for subsequent fund SBICs) with approximately \$2.363 billion of private capital. Of those, 28 were debenture SBICs and four were unleveraged SBICs. Through June 30 of the 2022 Federal FY, SBA licensed 19 SBICs (two for first-time SBICs and 17 for subsequent fund SBICs). Of these 19 SBICs, 16 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 that have interest payable just semi-annually. Most debentures bear a temporary interest rate until they are pooled and sold to the public. 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 133 basis points in excess of the interest rate on Treasury notes with 10-year maturities (Treasury Note Rate). In the most recent September 2022 debenture pooling of \$1.276 billion (which was the third largest in SBIC program history), the interest rate was 4.262% (excluding the annual SBA charge described below). This interest rate represented an 85 basis point premium to the Treasury Note Rate and reflected an increase from the 2.938% rate (excluding the annual SBA charge described below) set in the March 2022 pooling and the highest rate since the 4.084% rate set in the March 2011 pooling. As of June 30, 2022, there were \$11.840 billion of outstanding debentures, plus \$4.444 billion of undrawn commitments to issue debentures.

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. No energy-saving debentures have been issued.

Early Stage SBIC Initiative

On January 31, 2011, the Administration announced its Startup America Program, which, among other things, had as its purpose to promote high-growth entrepreneurship across the country with new programs to help encourage private sector investment in startups and small firms. As part of this initiative, SBA published final regulations on April 27, 2012 that established a new type of SBIC called an “Early Stage” SBIC. By their own terms, these regulations provided that the Early Stage Program would terminate on September 30, 2016. On September 19, 2016, SBA published a Notice of Proposed Rulemaking, which proposed various changes to the Early Stage Program. The proposed rule reflected SBA’s intent to continue licensing and providing SBA-guaranteed leverage to Early Stage SBICs beyond the initial five-year term previously announced and proposed regulatory changes. However, on September 28, 2017, SBA announced that it was not going to renew the Early Stage Program or finalize the proposed rule. In its memorandum announcing the nonrenewal of the Early Stage Program, SBA encouraged venture capital fund managers to apply for a license as a non-leveraged SBIC (*i.e.*, an SBIC that does

not utilize SBA debenture leverage).[5]

SBA licensed only five Early Stage SBIC's during the Early Stage Program's existence. SBA is no longer issuing leverage commitments to these Early Stage SBICs, however, they may continue to draw on their existing leverage commitments, subject to SBA regulations and policies.

Impact Investment Program

As part of the Startup American Program, SBA also approved the creation of an Impact Investment Fund Program and set aside an aggregate of \$1 billion of debenture leverage to be distributed over five years, beginning with the Federal FY 2011. On September 25, 2014, SBA announced policy changes for this program, including an extension of the program past the original five-year period and an intention to commit on average \$200 million per year to Impact SBICs. On February 2, 2016, SBA published a proposed rule which would create a new class of SBIC's called "Impact SBICs." However, on September 28, 2017, SBA announced the termination of the Impact Investment Program. In its memorandum terminating the program, SBA stated that, although it is terminating the Impact Investment Program, it remains committed to licensing qualified applicants, who intend to finance small businesses located in underserved areas or employ an investment strategy focused on social, environmental, and/or economic impact.

Accordingly, since November 1, 2017, SBA has not accepted "management assessment questionnaires" (MAQs) for applicants seeking to be licensed under the Impact Investment Program. Fund managers who submitted MAQs before September 28, 2017 were given an opportunity to convert to a standard SBIC applicant by providing written notice to SBA before October 28, 2017. Fund managers with existing green light letters from SBA authorizing them to submit an application for an SBIC under the Impact Investment Program are permitted to submit the license application consistent with the requirements contained in the green light letter. If any such manager is approved as an Impact SBIC, then it must operate under the Impact SBIC policy guidance under which it is licensed.

Licensed SBICs that are operating under the Impact Investment Fund Program are required to continue operations under the Impact SBIC policy guidance under which they were licensed and, if they were approved to issue debentures, SBA will continue its practice of approving leverage commitments and draws based upon SBA's regulations and credit policies that are applicable to all SBICs.

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 second funds (requiring successful operations of the first fund for at least two years, among other requirements). 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^[6] of leverage (subject to availability) and thereafter as needed for an amount of up to two tiers of leverage,^[7] but not more than twice in any Federal FY. 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 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 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.^[8]

Typical Use of Leverage

A management team may hold a closing and form its fund at any time before or after it files its formal SBIC application.^[9] However, it may not obtain leverage until it receives its license, a process that currently takes about six to 12 months from the date that SBA accepts a filed license application for processing. An SBIC license applicant is permitted to make investments only after SBA has formally notified the applicant in writing that the application has been accepted by SBA for processing. Thus, after the license application is accepted by SBA for processing, many applicants draw their private capital to pay organization expenses and management fees and to make investments. In any event, an SBIC must have drawn at least \$2.5 million of private investors’ capital prior to licensing. Once licensed, most 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 2-to-1. At that point, they generally coordinate capital calls from private investors with the use of leverage to maintain a 2-to-1 leverage-to-drawn private capital ratio.^[10]

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 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 debentures. SBA-guaranteed trust certificates for debentures are sold in March and September of each year. SBA obtains funds enabling it to supply leverage for debentures not pooled (including LMI debentures and Early Stage SBIC debentures) by guarantying loans made by the FHLBC.

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 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 2022, Congress authorized \$5 billion for leverage commitments. During the past five Federal FYs, SBA issued a total of \$12.198 billion of leverage commitments as shown in the following chart:

Federal FY	Leverage Commitments Issued by SBA
2017	\$1.960 billion
2018	\$2.522 billion
2019	\$1.614 billion
2020	\$2.102 billion
2021	\$4.000 billion

SBICs drew a total of \$10.186 billion of debenture leverage during the past five Federal FYs in the amounts shown in the following chart:

Federal FY	Leverage Drawn by SBICs
2017	\$1.902 billion
2018	\$2.119 billion
2019	\$1.927 billion
2020	\$1.796 billion
2021	\$2.442 billion

The trust certificates representing an interest in the pooled 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 pooling in September 2008. Since then the premium has decreased dramatically and, during the last five years, has generally been less than 1% (with the March 2020 pooling being the sole exception). The premium over the 10-year Treasury Note Rate for each of the last 10 poolings is shown in the following chart:

Pooling Date	10-Year Treasury Rate	Premium	Total Interest Rate (excluding SBA Charge)
March 2018	2.812%	0.375%	3.187%
September 2018	2.958%	0.590%	3.548%
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%

Historically, the amount of leverage commitments that SBA could issue each year was subject to annual Congressional appropriation of an amount necessary to cover anticipated losses on the leverage issued. Thus, the amount of Congressional appropriation and the rate of loss anticipated on the issued leverage (referred to as the subsidy rate) determined the actual amount of leverage available each year. This typically resulted in significantly less leverage being available than the level authorized by Congress. Beginning with September 1, 1996, SBA charged a 1% annual charge on leverage it provided to SBICs, causing significant reductions in required Congressional appropriations needed to support increasing amounts of available leverage. The amount of the charge is determined in the Federal FY in which a leverage commitment is issued and applies to all leverage issued pursuant to that commitment. The subsidy rate was substantially reduced in the case of debentures to less than 1% with the result that no appropriations were required to support their issuance beginning in Federal FY 2000.

In December 2000, legislation was enacted requiring SBA 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. The charge for leverage commitments issued since 2001 varied from a low of 0.222% for Federal FY 2018 to a high of 0.94% for Federal FY 2006. The charge for leverage commitments issued in Federal FYs 2017, 2018, 2019, 2020 and 2021 was 0.347%, 0.222%, 0.094%, 0.275% and 0.271%, respectively. The charge for leverage commitments issued during Federal FY 2022 is 0.173%.

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 2022 pooling pursuant to a leverage commitment issued during Federal FY 2021 was:

3.412%	10-year Treasury rate
<u>0.850%</u>	Premium required by trust certificate purchasers

0.271%

SBA charge for debenture commitment issued in Federal FY 2021

4.533%

Total Interest Rate

Repayment of Debenture Leverage

Debentures that have 10-year maturities from the date of pooling are not amortized prior to maturity, and bear interest payable semi-annually.^[11] Debentures are unsecured, and the general partner of the SBIC is generally not liable for their repayment. 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.^[12] SBA can issue debentures with maturities shorter than 10 years, but has not done so since 1991.

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

An SBIC using debentures makes distributions among its partners as provided in the SBIC's limited partnership or operating agreement. The sources of those distributions are limited as follows:

1. Distributions from positive "retained earnings available for distribution" (READ). An SBIC has READ if it has positive net realized cumulative retained earnings — these are the SBIC's cumulative earnings after all expenses and all realized and unrealized depreciation of investments have been deducted. An SBIC may distribute an amount equal to READ prior to repayment of its outstanding debentures. Note that SBA determines whether distributions have been made in excess of READ as of the end of each calendar year.
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.^[13]
3. After an SBIC has substantially completed making new investments, it generally files a "wind-up" 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.

Unlike conventional debentures, which are permitted to make distributions to its investors from READ before they are repaid, an Early Stage SBIC must make distributions to SBA concurrently with the making of any distributions to its investors. The amount that an Early Stage SBIC must distribute to SBA is determined by a formula based on the degree of capital impairment,^[14] a leverage ratio, and amounts previously distributed to SBA.

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. An SBIC using debentures is required to have total regulatory capital of at least \$5 million (\$20 million in the case of an Early Stage SBIC).^[15] 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.^[16]

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.^[17] 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.

Gramm-Leach-Bliley and Dodd-Frank Act Exemptions

As part of the Gramm-Leach-Bliley Act (GLB Act) implementation, effective April 1, 2002, the Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency adopted new regulations governing regulatory capital treatment for certain equity investments held by banks, bank holding companies, and financial holding companies. Under the regulations, an 8% tier-one capital deduction applies on covered investments that in the aggregate are less than 15% of an organization's tier-one capital, a 12% deduction applies to investments aggregating 15-24.99% of tier-one capital, and a 25% deduction applies to investments aggregating 25% and above of tier-one capital. The regulations exempt SBIC investments from such capital charges so long as their value is less than 15% of tier-one capital. However, the amount of SBIC investments will be considered when determining capital charges for other investments. These rules, however, may be affected by contemplated changes to bank capital requirements to conform to the Basel III Accords.

In addition, ownership of a 15% equity interest in a portfolio company by a bank-affiliated SBIC will not give rise to a presumption that the portfolio company is an affiliate under Sections 23(a) and (b) of the GLB Act.

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.^[18] SBA regulations define a small business as a company with tangible net worth (total net worth less goodwill) of less than \$19.56 million and average after-tax income (exclusive of loss carryforwards) for the prior two years of less than \$6.5 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.^[19] A smaller enterprise is a company with a net worth (excluding goodwill) 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^[20] 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); various real estate projects; single-purpose projects that are not continuing businesses; companies that will use the proceeds outside of the U.S. or 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.

An SBIC and its associates^[21] 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 19% or (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 14% or 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 a number of regulations and policies concerning 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 applying for a license after April 1, 2004, must 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 (semi-annually, 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. SBICs may only incur unsecured

debt.

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^[22] 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^[23] 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.^[24] 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. Leveraged SBICs that submit license applications from and after April 1, 2004, and which intend to use leverage, are permitted to charge an annual management fee of up to 2.5% of the sum of (i) the amount of its regulatory capital (adding back certain distributions made which reduced regulatory capital) and (ii) the amount of debenture leverage the SBIC plans to use that is approved by SBA, for five years, and thereafter 2.5% of the cost basis of loans and investments in active portfolio companies. However, if the base on which the fee is calculated exceeds \$60 million, the permissible rate declines to 2% when the base is \$120 million or more. SBA policies require 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). SBA's policies concerning management fees are quite detailed and are set forth in Tech Note 7A.^[25]

Licensing

SBA uses a two-step licensing process for first-time SBICs. In the first phase, an applicant completes and submits a "management assessment questionnaire" (MAQ) form to SBA. Effective October 1, 2021, an applicant must pay SBA a nonrefundable fee of \$10,500 at the time it submits the MAQ.^[26] The MAQ contains the elements of the applicant's business plan, as well as detailed information concerning the experience of each of the principals to carry out the business plan.

SBA generally requires that at least two, substantially full-time principals have at least five years of successful investment experience at a decision-making level in the types of investments the applicant is proposing to make.

Generally, each individual's track record 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. However, SBA does not want dominance by a single principal over investment and other management decisions (including personnel matters). They do not want to license a one-man band. SBA looks at the division of the SBIC's carried interest to evaluate relationships. They have an informal rule that no principal may own 50% or more of the carried interest unless there are only two principals, and they each have 50%.

The MAQ is then reviewed by SBA's Investment Committee, after which the principals, if appearing qualified, are invited to meet with the members of the Investment Committee. After the meeting with the applicant's principals, SBA's Investment Committee may deny the application or issue a green light letter, indicating the applicant has passed the first part of the application process and is authorized to file a formal application. At the present time, a green light letter usually is issued three to four months following submission of the MAQ and immediately after the interview.

An applicant that receives a green light letter must file its formal license application not more than 18 months after the date of that letter. The application fee for applications submitted between October 1, 2021 and September 30, 2022 is \$36,900.[\[27\]](#)

After receipt of the green light letter and obtaining commitments for at least the minimum required regulatory capital from investors satisfying the "diversity" requirement, the applicant files a formal application that contains additional information about the applicant and the management team, as well as the applicant's and its general partner's or manager's organizational applicant documents. Although SBA regulations require a debenture SBIC to have at least \$5 million of regulatory capital, SBA generally requires an SBIC to have firm commitments when its formal license application is filed for an amount of capital sufficient to enable the SBIC to have a first closing and conduct its operations, even if it does not subsequently raise additional funds. Depending on the projected size of the SBIC, SBA could require at least \$20-\$25 million of private commitments at the time the application is filed. During the formal licensing process, SBA tries to determine whether there is a qualified management team and if the SBIC has a good chance of operating profitably. SBA reviews the applicant's business plan, projections, and organizational documents, and conducts reference and other background checks (including litigation searches and an FBI fingerprint check) on the management team. The process currently takes approximately six to 12 months. SBA requires applicants to advise their investors that the investors are not entitled to rely on SBA's review of the applicant in deciding whether to invest.

After a license application is filed and accepted for processing by SBA, an applicant may make pre-licensing investments, which will be included in the applicant's regulatory capital if submitted to and approved by SBA prior to the investment being made. SBA requires 10 business days to review such pre-licensing investments (but approvals frequently take longer). SBA does not determine the quality or wisdom of the investment. Rather, SBA simply seeks to determine if the investment is made in compliance with SBA regulations. Once licensed, SBA pre-approval of investments is not required. Historically, SBA required all principals to attend a one-day regulations class run by SBA and only permitted one "pre-licensing" investment to be made before at least one principal

attended the class. However, SBA did not hold any classes in 2019 and 2020 and none are presently scheduled for 2021. Thus, SBA has not enforced this requirement recently.

Timeline

Applicants should assume the following timeline for securing a license and leverage.

Management Assessment Questionnaire	3-6 months
Formal License Approval	6-12 months
Receipt of Leverage Following Licensing	<u>1-2 months</u>
	10-20 months
Use of More than One-Half of One	6-10 months after
Tier of Leverage Following Licensing	licensing

This timeline assumes the license application is filed immediately upon receipt of the green light letter.

Licensing Second Funds

For second SBIC funds, SBA follows a process that is similar to licensing new funds with one important exception if certain conditions are satisfied. Instead of filing a MAQ, the process is initiated by submitting a formal written request asking SBA to issue a green light letter for the new fund. SBA now requires the submission of a nonrefundable fee in the same amount that would have been paid had a MAQ been submitted. To utilize this process and avoid writing a new MAQ to obtain a green light letter for a new fund, the management team and investment strategy of the new fund should be substantially the same as that of the existing SBIC. After submission of a request outlining the proposed new SBIC, SBA's Office of Operations compares the new fund and the prior fund(s) (similarity of business plan, changes in management team, track record, profitability, liquidity, and prior SBA compliance record) and makes a recommendation to the Investment Committee that in turn makes a decision whether to issue a green light letter for the new fund. Following receipt of that letter, when the new fund has received commitments for the minimum required capital that also satisfies the diversity requirement, the fund may submit a formal application for processing. Under SBA policy, the prior SBIC and the follow-on SBIC must each agree not to co-invest more than 30% of its investable capital with the other SBIC.

[1] U.S. Small Business Administration Offering Circular, Series SBIC 2022-10B, September 14, 2022.

[2] Small Business Administration – SBIC Overview Presentation, Updated January 1, 2019

[3] SBICs that have surrendered their licenses or have been transferred to the Office of Liquidation are not included in these figures.

[4] The federal fiscal year (Federal FY) starts on October 1 and ends on September 30.

