

New DOD/SBA Initiative Builds Technology Critical to National Security

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In late 2022, the U.S. Department of Defense's new Office of Strategic Capital (OSC) and the U.S. Small Business Administration (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. That encouragement comes mostly in the form of an innovative government-guaranteed financial instrument called the "Accrual Debenture."

SBICCT Overview

On December 3, 2022, the Department of Defense (DOD) and the SBA [announced](#) the SBICCT through a [joint letter signing event](#) at the *Reagan National Defense Forum* in Simi Valley, CA and attended by Secretary of Defense Lloyd J. Austin III and SBA Administrator Isabella Casillas Guzman. Then, on March 10, 2023, the DOD and the SBA signed a memorandum of agreement at the *South by Southwest Festival* in Austin, TX that outlined future OSC and SBA cooperation as to the SBICCT.

The SBICCT will run through the SBA's Small Business Investment Company (SBIC) financing program. An SBIC is a privately owned and operated investment fund licensed by the SBA that invests in American small businesses. This license allows the fund to access low-cost, long-term financing from the federal government to leverage its investments — up to \$2 in government guaranteed debt for every \$1 raised. The maximum amount of leverage a fund can receive from the SBA is the lesser of \$175 million or three times regulatory capital.

SBICs increase the pool of investment capital available to small businesses, while providing investors an opportunity to use a debt instrument to increase the amount of capital they invest and thus increase their potential returns. As of December 31, 2022, 305 licensed SBICs had received approximately \$22.11 billion in private capital and \$12.49 billion in outstanding SBA leverage. These SBICs invested in over 1,500 companies, creating and sustaining over 100,000 U.S. jobs.

The SBICCT continues the SBIC's long history of funding onetime, up-and-coming companies like Amgen, Apple Computer, Costco, Federal Express, Intel, Tesla, and Whole Foods. At the December 2022 signing event,

Defense Secretary Austin noted that the “Department of Defense depends on private capital to develop and commercialize critical technologies for our troops,” and the SBICCT will provide investment capital “to critical technology companies that otherwise wouldn’t get the necessary resources.”

On that note, the National Science and Technology Council’s [February 2022 Critical and Emerging Technologies List Update](#) includes almost two dozen “critical and emerging technology areas,” as well as approximately eight dozen subfields in those areas, in which we expect the DOD and SBA hope the SBICCT will bring more investments (and advances).

The Innovation: The Accrual Debenture

The SBICCT will utilize an innovative government-guaranteed financial instrument to help incubate and scale investments for capital-intensive technologies: the “Accrual Debenture.” The Accrual Debenture was created by the SBA’s proposed new rules and amendments under the Small Business Investment Act of 1958 to revise the SBIC program’s regulations, [published for comment in October 2022](#) but not yet finalized.

The SBA proposed the Accrual Debenture because it does not believe the standard SBIC debenture is aligned with “the cash flows needed for patient capital strategies solely investing in the equity of small businesses.” As proposed, the Accrual Debenture would accrue interest over its 10-year term, which would then be added to the principal at the end of the term, with the SBA guaranteeing all principal and unpaid accrued interest. As a result, no interest payments would be required until the end of the term. This is in contrast to the standard SBIC debenture that requires semi-annual interest payments to investors.

If an SBIC that issued an Accrual Debenture cannot pay the principal and accrued interest at the end of the 10-year period, it can apply for a rollover Accrual Debenture, which has a five-year maturation period. The maximum amount of leverage that an SBIC can have outstanding will be the aggregate of the total principal leverage plus 10 years of accrued interest on the principal.

Under the SBA’s proposed rules, Accrual Debentures will be available to long-term, equity-oriented funds licensed as “Accrual SBICs.” Under the proposed rule, an Accrual SBIC is one that will invest at least 75% of its total financings in equity capital investments, typically own 50% or less of the small business concern at initial financing, and elect at the time of licensing to issue Accrual Debentures.

On a related note, today, SBICs with outstanding debentures can make distributions to investors only from retained earnings available for distribution, which comprises cumulative realized profits minus unrealized losses on investments. Leveraged SBICs can also make distributions to investors as a reduction of regulatory capital, but must obtain SBA approval for any over 2%. Unleveraged SBICs can pass the 2% mark, but must notify the SBA of reductions in regulatory capital within 30 days and still meet minimum SBIC capital requirements.

However, the SBA’s proposed rule contains separate distribution requirements based on three categories of SBICs:

1. **Non-leveraged licensees.** These could make distributions to private investors without SBA prior approval so long as they retain enough regulatory capital to meet minimum requirements or are part of an SBA-approved

windup plan, allowing for a greater degree of flexibility;

2. **Leveraged licensees licensed prior to October 1, 2023 AND leveraged licensees wholly owned by business development companies that are not Accrual SBICs.** There is not much change for these SBICs; however, they could distribute retained earnings available for distribution only after considering material adverse changes to their portfolio; and
3. **Leveraged licensees licensed on or after October 1, 2023 not wholly owned by business development companies and Accrual SBICs.** These would have a distribution waterfall to repay the SBA the principal balance on outstanding leverage on at least a pro rata basis with private investors.

SBICCT Opens SBIC Doors to New Investors and Portfolio Companies

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 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.

But with the Accrual Debenture's generous repayment terms, the SBA could bring on more SBIC investments into growth equity and venture capital from patient private capital, which would benefit these companies and U.S. national security by speeding up their development of technology the DOD sees as vital to keeping the country safe in the future. The Accrual Debenture's payment terms support a longer horizon for investments than the Standard Debenture does.

We're still in the early days of the SBICCT, and there's no guarantee that the version of the Accrual Debenture in the SBA's proposed rule will be the same version established when the rule is finalized. But funds interested in obtaining a license to be an Accrual SBIC should stay abreast of developments regarding the SBA's proposed rule.

If the Accrual Debenture is enacted into law, the SBA through its partnership with the DOD will provide these funds a unique — and attractive — opportunity to invest in national security-related startups with federal money and favorable repayment terms.

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