

# SBA Proposes New Rules to Strengthen and Diversify Its SBIC Program

## WRITTEN BY

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A small business investment company (SBIC) is a privately owned and operated investment fund that makes long-term investments in American small businesses and is licensed by the U.S. Small Business Administration (SBA). SBICs invest billions of dollars in American small businesses — the drivers of economic growth and jobs in the United States. A fund primarily becomes licensed as an SBIC to obtain access to low-cost, long-term financing (leverage) from SBA to enable making these private investments.

On October 18, SBA proposed [new rules and amendments](#) under the Small Business Investment Act of 1958 to revise the regulations for the SBIC program. See also [proposed rules published in the October 19 Federal Register](#). SBA's proposal seeks to, among other things: (1) reduce barriers to program participation for new SBIC fund managers and funds investing in (a) underserved communities and geographies, (b) capital intensive investments, and (c) technologies critical to national security and economic development; (2) increase program investment diversification and patient capital financing for small businesses; and (3) modernize rules to lower financial barriers to program participation.

The primary elements of the proposed rules and amendments include the following:

### New Type of SBIC for Equity-Focused Funds

One key proposed change is the implementation of a new type of “Accrual Debenture” designed to align with the cash flows of long-term, equity-oriented funds licensed as “Accrual SBICs.” SBA presented its assessment that the SBIC program’s standard debenture does not align with the cash flows needed for patient capital strategies solely investing in the equity of small businesses. SBA observed that equity-oriented funds currently account for approximately 18% of SBA leverage, and credit/debt-oriented funds account for approximately 82% of capital from debenture SBICs. The proposed rule defines an “Accrual SBIC” as an SBIC licensee that will (1) invest at least 75% of its total financings (based on dollar amount) in equity capital investments;<sup>[1]</sup> (2) generally own no more than 50% of the small business concern at initial financing; and (3) elect at the time of licensing to issue Accrual Debentures. It also defines an “Accrual Debenture” as a debenture issued at face value that would accrue interest over its 10-year term (as opposed to requiring semi-annual interest payments associated with standard debentures) where SBA guarantees all principal and unpaid accrued interest. The Accrual Debenture would only be available to Accrual SBICs to align with the types of equity investing they perform. In addition, if a licensee that issued an Accrual Debenture cannot pay the principal and accrued interest at its 10-year maturity, that licensee may apply for a rollover Accrual Debenture, which would have a five-year term. To determine the maximum amount of leverage that Accrual SBICs may have outstanding, SBA will aggregate the total principal leverage ***plus***

## **10 years of accrued interest on such principal.**<sup>[2]</sup>

### **Distributions and Reductions in Regulatory Capital**

Under current SBA regulations, an SBIC with outstanding debentures can only make distributions to its investors from retained earnings available for distribution (READ). READ consists of the SBIC's cumulative realized profits, less unrealized losses on investments. An SBIC also can make distributions to its investors as a reduction in the SBIC's regulatory capital, but it may not return more than 2% of its regulatory capital to investors in any fiscal year without SBA's prior approval. Unleveraged SBICs are permitted to make distributions without regard to these limitations, so long as they notify SBA of any reductions in regulatory capital within 30 days and meet the minimum capital requirements under SBIC regulations.

SBA proposes to separate distribution requirements based on three categories of SBICs: (1) non-leveraged licensees;<sup>[3]</sup> (2) leveraged licensees<sup>[4]</sup> licensed prior to October 1, 2023, and leveraged licensees wholly owned by business development companies (BDCs) that are not Accrual SBICs; and (3) leveraged licensees licensed on or after October 1, 2023 not wholly owned by BDCs and Accrual SBICs. The proposed rules would permit non-leveraged licensees to distribute to their private investors without SBA prior approval, as long as they retain sufficient regulatory capital to meet minimum capital requirements under SBIC regulations, unless such amounts are in accordance with their SBA-approved windup plan. For the second category of SBICs, SBA proposes substantively the same requirements as in the current regulations except to provide that such SBICs may distribute READ only after considering any material adverse changes to its portfolio. For the third category of SBICs, SBA proposes a distribution waterfall that repays SBA the principal balance on outstanding leverage on at least a pro rata basis with private investors.

### **Leverage Commitment Approval Process**

Instead of applying for multiple leverage commitments following licensing, SBA proposes to approve the "total leverage commitment"<sup>[5]</sup> for the life of the SBIC at the time of licensing. In this regard, SBA noted that although it recognizes that many SBICs continue their fundraising activities after being licensed, it expects that SBIC license applicants complete their fundraising before submitting their applications for final review. This will significantly alter the fundraising practices of most SBICs, as well as the investment and underwriting process for many investors in SBICs.

### **Qualified Line of Credit**

Current SBA regulations require an SBIC to obtain prior SBA approval to incur secured third-party debt. SBA proposes a new secured "qualified line of credit" concept that would be exempt from mandatory SBA prior approval if it meets certain requirements regarding the overall size, term, holder, and borrowings under the credit facility. The line of credit must be limited to 20% of total unfunded binding commitments from institutional investors, cannot exceed a term of 12 months,<sup>[6]</sup> and must be held by a federally regulated financial institution. All borrowings under the line of credit must be: (1) secured only by unfunded regulatory capital up to 100% of the amount of the borrowing and 90 days of interest; (2) for the purpose of maintaining the SBIC's operating liquidity or providing funds for a particular financing of a small business; (3) fully repaid within 90 days after the date they are drawn; and (4) fully paid off for at least 30 consecutive days during the SBIC's fiscal year, so the outstanding

third-party debt is zero for at least 30 consecutive days.

### **3(c)(7) Fund Exception From “Affiliate” Definition for Small Business Size Regulations**

SBA proposes to amend the small business size standards affiliation exceptions for the SBIC program to also except private funds exempt from registration under the Investment Company Act of 1940 (Investment Company Act) under Section 3(c)(7) of the Investment Company Act, in addition to the current exception for traditional investment companies under 13 CFR 107.150(b)(2) and private funds exempt from registration under Section 3(c)(1) of the Investment Company Act.

### **Investments in Relenders or Reinvestors**

SBICs are prohibited from investing in relenders or reinvestors, except in the case of a narrow exception. SBA proposes to expand this exception to allow for investments in equity securities to “underserved”<sup>[7]</sup> relenders or reinvestors (except banks or savings and loans not insured by federal government agencies, as well as agricultural credit companies) that make financings solely to small business concerns that a licensee may directly finance.

### **Financings With Associates**

SBA proposes to introduce a safe harbor for financing a portfolio concern by an associate of the SBIC when an outside third party is investing in the small business at the same time and on the same terms and conditions as the SBIC, and it represents a significant portion of the financing.

### **Valuation Reporting and Policy Changes**

For all leveraged licensees, SBA proposes to increase the frequency of valuation reporting from semi-annually to quarterly, commensurate with the required quarterly reporting of the Form 468. SBA also proposes to expand the timeframe for quarterly valuations, including material adverse changes, to 45 calendar days following the close of each quarter, instead of within 30 days following the close of each quarter.

The proposal also seeks to require leveraged licensees to provide valuations based on SBA valuation guidelines **and in accordance with GAAP**.<sup>[8]</sup> Non-leveraged licensees, under the proposed rules, may adopt a valuation policy in accordance with GAAP only.

### **Form 468 Filing Due Dates**

SBA proposes to make the annual Form 468 due date within 90 calendar days following the end of the fiscal year, instead of the current requirement to file on or before the last day of the third month following the end of the fiscal year. SBA also proposes an amendment that leveraged licensees must submit quarterly Form 468s within 45 days after the close of each quarter, instead of the current requirement for SBICs with outstanding leverage commitments to submit quarterly Form 468s within 30 days after the close of each quarter.

### **Portfolio Financing Report Filing Due Date**

SBA proposes to make the requirement to submit a portfolio financing report on SBA Form 1031 be due within 30 calendar days of the end of the calendar year quarter following the closing date of a financing, instead of the current requirement to file within 30 days of the closing date of a financing.

## Licensing Fees

SBA proposes to modify its licensing fees to lower financial barriers for new funds to increase SBIC program participation and reduce existing burdens for SBICs. SBA is proposing to revise the licensing fees based on its fund sequence (meaning the order of succession of the fund) as follows:

Fund Sequence	Initial Licensing Fee	Final Licensing Base Fee
Fund I	\$5,000	\$10,000
Fund II	\$10,000	\$15,000
Fund III	\$15,000	\$25,000
Fund IV+	\$20,000	\$30,000

The “final licensing fee” would consist of the “final licensing base fee” plus 1.25 basis points multiplied by the leverage dollar amount requested by the applicant. SBA’s proposed changes would effectively lower the combined licensing fee for all non-leveraged applicants and lower the fees for applicants with less SBA capital at risk and new funds.

## Leverage Fees and Annual Charges

SBA is required to establish an “annual charge” (not to exceed 1.38%) on leverage commitments issued each federal fiscal year at the rate necessary, so the sum of all fees charged by SBA would equal the amount of anticipated losses on the leverage issued. Since 2000, this “annual charge” has varied from a low of 0.047% for the current 2023 federal fiscal year to a high of 0.94% for the 2006 federal fiscal. SBA proposes to set the minimum “annual charge” to 0.50% or 50 basis points.

## Examination Fees

SBA proposes to change the formula for examination fees for SBICs to equal \$10,000 + 0.035% of their total leverage commitment established at licensing, with two exceptions. First, non-leveraged licensees with more than \$50 million in assets at cost would pay an additional \$20,000. Second, leveraged licensees licensed prior to 60 days after the date of final rule publication in the *Federal Register* will have a base fee calculated as \$10,000 + 0.035% multiplied by (outstanding leverage + SBA undrawn leverage commitments).

## Licensee’s Capital Impairment

SBA proposes to remove the existing requirement for licensees to calculate their capital impairment percentage and notify SBA if they have a condition of capital impairment. Instead, SBA proposes that SBA will calculate the licensee’s capital impairment percentage each quarter and notify the SBIC if they are capitally impaired.

## Enhanced Monitoring

SBA proposes to introduce “enhanced monitoring,” which requires a heightened level of reporting and monitoring for licensees that have presented a risk to SBA. A licensee can be added to enhanced monitoring status for a series of actions, bottom quartile performance relative to the licensee’s stated benchmark for more than four consecutive quarters, or reporting failures defined in SBIC program policies and procedures. While on enhanced monitoring status, the licensee must file Form 1031 on a more frequent basis, and upon request, conduct portfolio review meetings with SBA.

### **Nonprofit Exception From Management Ownership Diversification Requirements**

The proposal would permit nonprofit entities to own more than 70% of an SBIC’s regulatory capital to facilitate capital raising efforts, particularly for first-time funds and funds targeting investments in underserved geographies and critical technologies.

### **Minimum Regulatory Capital Exceptions and Priority Considerations for Licensees Headquartered in Underlicensed States**

SBA proposes to add an exception to the \$5 million minimum regulatory capital requirement if the SBIC was licensed because it is headquartered in an “underlicensed state.”<sup>[9]</sup> Such licensees would also be limited to leverage up to 100% of regulatory capital until they raise \$5 million in regulatory capital. SBA also proposes to give priority in both phases of the licensing process (initial review and final licensing) and with respect to approving leverage commitments to SBICs headquartered in underlicensed states with below median SBIC financing dollars.

The comment period will remain open until December 19, 2022. If the proposed amendments are adopted, they would have a significant impact on the SBIC program.

For a more detailed description of the SBIC debenture program, go to <https://www.troutman.com/insights/description-of-the-small-business-investment-company-debenture-program-september-2022.html>.

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<sup>[1]</sup> The term “equity capital investments” refers to equity and equity-like investments defined in 13 CFR 107.50 to include common or preferred stocks, limited-partnership interests, certain subordinated debt, and warrants.

<sup>[2]</sup> For example, an Accrual SBIC with \$100 million in regulatory capital may be approved for only \$118 million in leverage (as opposed to the statutory maximum of \$175 million) if the forecasted interest would accrue to approximated \$57 million over a 10-year timeframe at a 4% interest rate.

[3] Under the proposed rule, a “non-leveraged licensee” would be a licensee that has no outstanding leverage or leverage commitment, certifies (in writing) that such licensee will not seek leverage throughout the life of the fund, and has no earmarked assets.

[4] Under the proposed rule, “leveraged licensees” would include any licensee with outstanding leverage, leverage commitments, earmarked assets (which are only associated with licensees that issued participating securities), and any licensee that intends to issue leverage in the future.

[5] SBA proposes that “total leverage commitment” would mean the total leverage commitments available to the SBIC for the life of the SBIC, subject to SBA regulations.

[6] The 12-month duration of the qualified line of credit may be renewable on an annual basis if it remains in compliance with the regulation.

[7] “Underserved” is an undefined term, which allows SBA more flexibility to clarify what constitutes “underserved” through policy notices.

[8] SBA also proposes to define the term “GAAP” as “generally accepted accounting principles” as established by the Financial Accounting Standards Board, which refer to financial accounting and reporting standards for public and private companies and not-for-profit organizations in the United States.

[9] SBA proposes that an “underlicensed state” would mean a state in which the number of operating licensees per capita is fewer than the median number for all states.

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