SMALL BUSINESS INVESTOR ALLIANCE:

Capital Formation Agenda

Legislative Recommendations for Members of the 114th Congress
DEAR MEMBER OF CONGRESS,

We believe public policies that help small businesses gain access to capital is crucial to our nation’s economic growth and job creation, and access to growth capital should be at the forefront of the Agenda.

The Small Business Investor Alliance (SBIA), the nation’s premier organization for lower middle market investors, submits to you the SBIA: Capital Formation Agenda; Legislative Recommendations for Members of the 114th Congress, a public policy guide designed specifically for Congress. These legislative recommendations, when enacted into law, will provide the essential means to increasing capital access for small businesses.

Please take a look at this guide to learn more about how small business investors are making a difference in the capital formation process. Additionally, we hope you can support our legislative agenda by sponsoring and voting yes for these initiatives on the House or Senate floor.

Please let us know if you have any specific questions about this agenda. Our legislative team welcomes the opportunity to meet with you or your staff at your convenience.

I look forward to working with you to promote capital formation for our nation’s small businesses.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance
Capital Formation Agenda

Legislative Recommendations for Members of the 114th Congress
ABOUT THE SMALL BUSINESS INVESTOR ALLIANCE

The Small Business Investor Alliance (SBIA) is the premier organization of lower middle market private equity (PE) funds and investors. SBIA members provide vital capital to growing small and medium sized businesses nationwide, resulting in job creation and economic growth.

SBIA member funds employ various investment strategies including growth equity, mezzanine, debt, buyout, and venture capital. SBIA member funds invest long-term capital in domestic small businesses in nearly every state across the country.

Most members of SBIA are structured as private equity partnerships, pooling capital from limited partners to invest in companies nationwide. A primer on private equity can be found on page 20. About half of the SBIA member funds are licensed as Small Business Investment Companies (SBIC). SBICs are U.S. Small Business Administration (SBA)-regulated investment vehicles that can borrow up to two times the private capital they raise to invest in small businesses. See page 23 for more background on the SBIC Program.

A growing number of SBIA members are structured as Business Development Companies (BDCs), which are SEC-regulated investment vehicles that raise money from retail investors through private and public offerings. See page 26 for a primer on BDCs.

The SBIA membership also consists of institutional limited partner investors in these funds. These limited partner (“LP”) investors are banks, family offices, funds of funds, and insurance companies.

SBIA is the leading advocate in Washington, D.C., representing private equity funds, BDCs, and SBICs. SBIA has been serving a pivotal role in promoting the growth and vitality of the lower middle market for more than 50 years.
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SBIA Members primarily invest their capital in “lower middle market” businesses, which are small businesses that generate between $10 and $100 million in revenues per year.
Private equity and job creation

WHY ARE SMALLER PRIVATE EQUITY FUNDS SO IMPORTANT TO CREATING VALUE AND ADDING JOBS?

According to a 2012 Pepperdine University study, private equity-backed establishments generated 129 percent more revenue growth and 257 percent more employment growth than their non-private equity-backed counterparts.¹

SBIA Members primarily invest their capital in “lower middle market” businesses, which are small businesses that generate between $10 and $100 million in revenues per year. Middle market companies account for ¹/³ of private U.S. employment, or 45 million jobs. According to research by the National Center for the Middle Market, middle market companies have recently been the strongest sector of the economy in terms of revenue and employment growth, with annual revenue growth of 6.6 percent and annual employment growth of 3.2 percent in 2014.²

Revenue growth for lower middle market companies has been significantly more stable and higher than for S&P 500 firms. Entering 2015, smaller companies were expected to continue growing revenues at about a six percent rate which is higher than expectations for S&P 500 companies.

Employment growth at lower middle market businesses was in line with large businesses for most of 2013, before taking a sharp upward turn in the first half of 2014. Employment prospects for smaller businesses entering 2015 continue to be robust with projections greater than four percent.
SBIA Portfolio Company of the Year

The SBIA Portfolio Company of the Year Award recognizes the effectiveness of private equity financing and the benefits of the partnership between private investors and small businesses. This competitive award is given annually by the SBIA to the small business that demonstrates consistent strong growth characteristics and robust financial performance while also providing increased employment opportunities in the local markets in which it operates.

SBIA’s Portfolio Company of the Year Award has been presented to 35 outstanding SBIA-member portfolio companies since 1987. Previous award winners have included such well-known companies as Intel, Callaway Golf, and Build-A-Bear Workshop.

Green Compass, a portfolio company of SBIA member C3 Capital, won the prestigious 2014 SBIA Portfolio Company of the Year. Green Compass is a leading provider of waste water treatment solutions. Through the partnership, C3 Capital and Green Compass expanded waste water treatment services to new markets and created jobs in those areas.

Located in Oxnard, California, Green Compass has treatment facilities in Kern County, Orange County, and Ventura County, which includes a 12.6 mile pipeline connection to the municipal water treatment facility in Santa Paula. The company was founded in 1959 with six employees and has grown to over 120 employees across its four California locations. In 2014, the company processed approximately 100 million gallons of waste water.
SBIA Capital Formation Legislative Agenda

SBIA Recommendation:

Increase SBIC Family of Funds Statutory Limitation

The Small Business Investment Company (SBIC) Program was signed into law in 1958 by President Dwight Eisenhower to stimulate the flow of long-term patient capital to domestic small businesses. Today, there are over 240 licensed SBICs across the country with over $22 billion in total assets. In Fiscal Year 2014, SBICs invested more than $5.2 billion in new capital to small businesses nationwide. Since 2009, SBIC investments have provided critical capital to small businesses, and this growth capital has increased 33 percent per year.

BACKGROUND OF THE SBIC FAMILY OF FUNDS LEGISLATION

The SBIC “Family of Funds” limit is a statutory cap that is currently restricting proven small business investors from accessing new SBIC leverage. As many as 40 SBIC “Family of Funds” investors—which are SBICs under the same management umbrella—are hitting the cap or will hit the cap if they raise their next fund. If Congress increases this cap, SBIA estimates that SBICs will facilitate up to $750 million a year in new small business investing.

According to the Congressional Budget Office, increasing the family of funds limit would not increase federal spending. The provision has broad bipartisan support in both the House and Senate. SBIA recommends raising the family of funds cap from $225 million to $350 million.

LEGISLATIVE HISTORY OF THE SBIC FAMILY OF FUNDS LEGISLATION

Congressman Steve Chabot (R-OH), the current Chair of the House Small Business Committee, introduced legislation in the 112th and 113th Congress (H.R. 6504 and H.R. 1106, respectively) to increase the SBIC family of funds limit from $225 to $350 million. The House of Representatives passed H.R. 6504 by an overwhelmingly bipartisan 359-36 vote on December 18, 2012. Senator Jim Risch and Senator Mary Landrieu introduced the Senate version of the bill during the 113th Congress (S. 550 and S. 511, respectively). S. 511 passed unanimously out of the Senate Small Business Committee on September 10, 2013.
Total Small Business Investment Companies
Investments by State (FY 2010-2014)
“It’s important for my colleagues to know that this bill does not cost the taxpayers’ money, nor does it increase the risk of the program. The SBIC debenture program will remain a zero subsidy program. That means that the SBICs that participate must pay an up-front fee to cover any losses. It’s good public policy like this that truly helps business grow and access capital at no cost to taxpayers.”


“Over the past five years, SBICs have invested over $13.5 billion in small businesses nationwide. This simple bipartisan fix will enable SBICs to invest billions more in capital to small businesses in the next few years alone.”

Steve Hobman, NewSpring Capital, an SBIC based in Philadelphia, PA

Steve Hobman, General Partner, NewSpring Capital, an SBIC based in Philadelphia, PA
SBIA Recommendation:

Modernize Business Development Companies for the 21st Century

Business development companies ("BDCs") were created in 1980 by Congress to spur investment in small and mid-sized businesses. Today, this industry is growing rapidly and providing capital to small and mid-size businesses across the country, filling gaps that have been vacated by traditional lenders. BDCs allow retail investors an opportunity to invest in small and mid-size companies by purchasing shares of publicly-traded BDCs.

Modernizing the regulations that impact BDCs will unleash more capital for job creation and business growth and help the industry mature to reach its full potential. SBIA is the only collective voice for BDCs on Capitol Hill and is committed to encouraging capital formation and realizing Congress’ intent when they created BDCs in 1980.

BACKGROUND OF BDC LEGISLATION

The Modernization of BDC regulations will allow BDCs to deploy more capital; they are currently limited to a 1:1 debt-to-equity ratio as opposed to banks and other financial vehicles that are often leveraged at a 9:1 ratio or higher. Allowing a modest increase in the leverage for BDCs will enable them to deploy significantly more capital to small and mid-size businesses, while simultaneously reducing the risk in their portfolios.
as they can invest in lower yielding, lower risk investments and still generate valuable returns to their shareholders. The modernization legislation also includes provisions to streamline the offering, filing, and registration processes for BDCs at the Securities and Exchange Commission (SEC), eliminating significant regulatory burdens.

**THE BDC INDUSTRY—PROVIDING CRITICAL CAPITAL**

Currently, there are over 70 BDCs in existence and the sector is growing rapidly. Total outstanding loan balances by the BDC industry to small and medium businesses has grown from $10 billion in 2007 to over $65 billion during the fourth quarter of 2014.

**LEGISLATIVE HISTORY OF BDC MODERNIZATION LEGISLATION**

BDC Modernization legislation was introduced in the 113th Congress (H.R. 1800). The House advanced the bill, passing it out of the House Financial Services Committee on November 14, 2013. No further action was taken in the 113th Congress.

“H.R. 1800…will increase the ability of Business Development Companies to lend to small businesses and help ensure the flow of capital to Main Street.”

—Jeb Hensarling, Chairman, House Financial Services Committee, November 14, 2013.

*Modernizing the regulations that impact BDCs will unleash more capital for job creation and business growth...*
“The Investment Company Act of 1940 places very significant operational restrictions on BDC’s including severely limiting the ability to deploy leverage, restrictions on ownership of registered investment advisers, prohibitions and limitations on many types of joint and affiliated transactions, and requiring extensive public disclosure on everything from its portfolio investments to its financing arrangements.”

—Curtis Hartman, Chief Credit Officer, Main Street Capital, a BDC in Houston, Texas.

“BDCs can fill a larger void for small business capital if Congress modernizes the current BDC regulatory structure. BDCs are currently being held back on their ability to grow their capital structure, with restrictions placed on leverage levels and preferred stock. BDCs are also left at a disadvantage when they offer their securities on market exchanges and in their compliance and reporting responsibilities with the Securities and Exchange Commission (SEC).”

—Tom Aronson, Managing Director, Monroe Capital, a BDC in Chicago, Illinois

“While the BDC industry continues to grow, I strongly believe that we can expand our scope and do more to fulfill our policy mandate. To that end, I am here today on behalf of the BDC industry to express support for current proposed legislation that seeks to make straightforward, prudent changes to the Investment Company Act of 1940 in order to enable BDCs to more easily raise and deploy capital to small and medium size businesses. It is important to note that BDCs are not seeking any government or taxpayer support or subsidy. The BDC industry is simply asking Congress to modernize their regulatory framework so that BDCs can more easily fulfill their Congressional mandate.”

—Michael Arougheeti, CEO, Ares Capital Corporation, Testimony before the House Subcommittee on Capital Markets & GSEs, October 23, 2013.
SBIA Recommendation:

Provide Regulatory Relief for Small Business Investors

Under the 2010 Dodd-Frank Act, the regulatory landscape for private equity funds changed dramatically. The changes require most private equity funds to register with the SEC as investment advisers, and smaller private equity advisers to register or report to the SEC or their state securities regulator. SEC registration is expensive and, in most cases, the investment adviser rules are not designed for private equity funds. For example, the initial cost to register with the SEC is often in excess of $100,000. Annual costs to comply with SEC Investment Adviser rules are often $250,000 or more per year. Additionally, most SEC investment adviser regulations are designed to protect retail investors and are more applicable to publicly traded companies, not for small business investing.

SBIA supports exempting small business investors from the Investment Advisers Act. The $150 million threshold that triggers SEC registration is too low and, at a minimum, the threshold should be raised. Additionally, Congress should work expeditiously to clarify the exemption threshold for SBICs and streamline the rules for smaller PE funds.

Small business investors commonly have very few employees, sometimes as few as two. Small business investment funds generally do not have legal departments, compliance teams, or extra employees to dedicate to adhering to a complicated regulatory regime not designed for their type of investing. Adding additional overhead expenses for regulatory compliance teams and services severely restricts the ability of small business investment funds to operate profitably.

The Complex Case of Dodd-Frank: Different Rules for Different Private Equity Funds

Dodd-Frank created an “Assets Under Management” (AUM) test to determine how most advisers of Private Equity Funds are regulated. Other types of fund advisers are specifically exempt from registration, such as Venture Capital (VC) Funds and Small Business Investment Companies, but only if they “solely” advise those funds.

<table>
<thead>
<tr>
<th>Size or Type of Fund Test</th>
<th>Regulatory Regime</th>
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<tr>
<td>Fund advisers that advise PE Funds with more than $150 Million in AUM</td>
<td>Register with the SEC as Investment Adviser</td>
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<tr>
<td>Fund advisers that advise PE Funds with between $100-150 Million in AUM</td>
<td>Regulated by the SEC as “Exempt Reporting Adviser”; i.e., no registration, no examinations, but some paperwork and reporting</td>
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<tr>
<td>Fund advisers that advise PE Funds with less than $90-100 Million in AUM</td>
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<td>Advisers that “solely” advise SBIC Funds</td>
<td>SBICs are already Regulated by the SBA. Therefore, Congress exempted these funds from SEC Registration but, depending on state law, may have to register with the state regulator.</td>
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<td>Advisers that advise SBIC Funds and VC Funds</td>
<td>SBICs and VC Funds Lose their Exemption and Must Register if AUM is greater than $150 Million. This Results in Double Regulation by SEC and SBA for SBIC Funds.</td>
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<td>Advisers that advise SBIC Funds and PE Funds</td>
<td>The SEC Counts the SBIC AUM in the SEC Registration threshold, triggering automatic registration if above $150 Million in AUM. This Results in Double Regulation by the SEC and SBA for SBIC Funds.</td>
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SBIA Recommendation:

Eliminate Double Regulation for SBICs

SBIA supports clarifying and streamlining this duplicative regulatory regime for advisers who manage both SBICs and other types of VC or PE Funds. Legislation is needed to:

1. Eliminate duplicative registration of advisers solely to SBICs, removing the potential of two regulators at the state and federal level.

2. Allow venture capital advisers to retain their exemption in Dodd-Frank if they choose to also advise an SBIC fund.

3. Assist advisers that manage both traditional private equity funds and SBICs by exempting the SBIC capital already regulated by the SBA from the SEC registration calculation.

LEGISLATIVE HISTORY OF SEC INVESTMENT ADVISER RELIEF LEGISLATION

When creating this provision in Dodd-Frank, it was clear that double regulation was to be avoided, but that is not the way it has been applied.

Congressman Blaine Luetkemeyer (R-MO) introduced the SBIC Advisers Relief Act (H.R. 432) on January 21, 2015. H.R. 432 clarifies the Investment Advisers Act for certain advisers of SBICs. During the 113th Congress a similar version of the bill (H.R. 4200) passed the House Financial Services Committee 56-0 on May 22 and unanimously passed the House of Representatives on December 2.

In the 113th Congress, Congressman Robert Hurt (R-VA) and Congressman Jim Himes (D-CT) introduced H.R. 1105, the Small Business Capital Access and Job Preservation Act. The legislation removed SEC registration for private equity firms while maintaining certain investor safeguards. This bill passed the House of Representatives on December 4, 2013.
“If an adviser advises for SBICs and any other private funds and the total assets under management exceed the $150 million registration threshold (as it does for Ironwood Capital) the threshold for full registration is triggered. The double counting of capital, even otherwise exempt capital, causes double regulation for advisers that advise SBICs and any other private funds (non-SBICs). Firms should not be required to count the SBIC exemption as part of the $150 million threshold. Congress did not intend for firms to face the threat of double regulation, and it is important to remove the double regulation of SBICs and non-SBICs.”

—Marc Reich, President, Ironwood Capital, a private equity fund in Avon, Connecticut.

“SEC registration has added costs to Centerfield in the form of higher compliance costs and fees. Incremental costs have been incurred for services rendered by third party legal and compliance professionals to ensure that our policies and procedures incorporate the various SEC requirements, many of which are not applicable to private equity. Such resources have also been used for SEC examination preparedness. The fees charged by our external auditors have increased to meet the accounting firm’s higher standards for SEC registrants. These out-of-pocket costs and the time spent by our professionals on SEC registration and compliance detract from our mission of empowering small businesses to grow.”

—Faraz Abbasi, Senior Partner, Centerfield Capital, a private equity fund in Indianapolis, Indiana.
**SBIA Recommendation:**

Create a Stronger Voice at the SEC for Small Business Interests

The SEC is not designed or focused on small business *capital formation*. It needs an Office of the Small Business Advocate focusing on capital formation. A new Office of the Small Business Advocate could provide an independent voice on small business concerns, particularly ways in which the SEC can be helpful in encouraging capital formation to help those businesses grow. Having this additional voice at the SEC will provide much needed insight and contribute the views of small businesses, which currently do not receive sufficient attention at the Commission. The Advocate should be directed to coordinate the SEC’s Advisory Committee on Small & Emerging Companies and the Government-Business Forum, both incubators of important ideas designed to help encourage smart improvements to the securities laws and develop initiatives to facilitate capital formation in the real economy.

“I believe the SEC needs to create an Office of the Small Business Advocate, reporting to the Commission. This office would be modeled on the Office of the Investor Advocate created by the Dodd-Frank Act. There’s a natural parallel here, in that our staff perennially faces difficulty in receiving views from certain segments of the market that find it difficult and expensive to participate in the normal notice and comment rulemaking process: retail investors and small businesses. Having a single point of contact for outreach for these underrepresented groups, who can then turn around and advocate their views to the staff, is critical. Finally, just as the Investor Advocate now runs the Investor Advisory Committee, the Small Business Advocate could take charge of the SEC’s Advisory Committee on Small and Emerging Companies and the Government-Business Forum, an incredibly important group that does not have the profile it deserves at the Commission.”

—Commissioner Daniel Gallagher, U.S. Securities & Exchange Commission, September 17, 2014
SBIA Recommendation:

**Improve SBIC Program Operations**

In order to continue the strong success of the SBIC program, the program must constantly update its rules and regulations. SBIA supports any legislative initiatives that will ensure more effective and efficient use of SBA resources and taxpayer dollars, streamline the program to enable increased participation from the private sector, and update the program to keep pace with technological changes.

SBIA recommends modernizing the SBA by requiring the SBA to accept electronic signatures and records on behalf of program participants when certifying and transmitting documents. This common-sense approach will result in significantly less physical paper at the SBA, faster turnaround times in the program for SBICs, and an updated program for the 21st century.

Additionally, SBIA recommends requiring the SBA to fix its licensing process by streamlining licensing for SBICs applying for a repeat license. This would apply to SBICs with a strong track record and the same management team that are returning to the SBA to be licensed. Instead of forcing these successful SBICs to go through a long re-licensing process, legislation could be adopted to streamline the re-licensing process for proven funds. This would reduce the burden on the SBA's resources in the program and speed up the licensing of new funds; therefore, increasing the effectiveness of the program, while still securing the quality of the funds being re-licensed. SBIA believes this approach would help eliminate uncertainty for funds coming back for re-licensing, speed processing times for new funds, and eliminate the crunch of limited resources at the SBA.

“There are a number of major technological and information systems challenges that make it very difficult for SBA staff to administer the SBIC program effectively. We encourage a meaningful review and improvement in both the technological tools and the policies around them. One of the major problems for SBIC funds is the inability of the SBA to accept documents electronically. The SBA still requires SBICs to send hard copies for most documentation requests. The email system at SBA is unable to send or receive many documents. It is common that critical documents are delayed or lost in the mail room. The SBA needs to be able to communicate electronically. Further, it has been over a decade since laws were changed to require the acceptance of digital signatures, but the SBA requires paper copies, often with multiple copies. The SBA needs to modernize its documentation collection process to allow SBICs to communicate and submit documents electronically.”

SBIA Recommendation:

Don’t Pass Punitive Tax Increases on Small Business Investors

Private Equity investing involves the long-term investment of patient capital that provides a return years after the initial investment is made. As a result of the long-term nature of these investments, the returns from these investments are treated as a long-term capital gain under the tax code, and are taxed at a lower rate than regular income. This concept is known as “carried interest.” Through this investing structure, the general partner (GP) is compensated through “carry” only if the fund is successful, as investors must receive back the value of their initial investment, as well as a certain specified profit percentage, before the GP receives their return. In this manner, the general partners’ economic interests are aligned with those of the capital investors.

A partner’s share of income is subject to the entrepreneurial risks of the partnership’s business. Any change in carried interest would distort the economic interests between the fund managers and the outside capital investors, eliminating the alignment that has resulted in successful deals and better value creation for domestic small businesses.

The carried interest is also typically subject to a “clawback” provision that requires the PE firm to return distributions to the extent of any subsequent losses in other investments of the fund. If the fund generates losses on some investments, the GP shares in the downside because any profits from its carry from successful investments are offset by the unsuccessful deals. If enough deals in a fund do poorly, the GP could be left with no carry at all.

IF THE CARRIED INTEREST MODEL IS DESTROYED, SMALL BUSINESS INVESTORS WILL BE HURT MOST

Private equity funds hold portfolio company investments in a bucket of companies and the size of the fund matters in determining these investments. Small private equity funds do not have the capacity to invest in large businesses. The scale of their funds allows a portfolio of $10 to $20 million investments in 20 businesses, not one $500 million investment in only one company.

For smaller funds, if the carried interest tax rate increases dramatically, it makes less sense economically to be able to sustain a fund. The smaller the fund, the less it will be able to withstand an increase in the tax rate for carried interest because smaller funds cannot survive solely on asset-based management fees. As a result, there will be fewer smaller investment funds and therefore less capital available for small business.

How Does Carried Interest Work?

Private equity funds pool the capital of investors and invest this capital into venture and growth companies. Managers of these funds typically receive an annual management fee of two percent of the fund’s committed capital and eligibility for a 20 percent share in the profits of the fund. The 20 percent profit sharing interest is referred to as the “carried interest.” In most cases, the carried interest is not realized for fund managers until the investors’ capital is paid back with interest, which usually occurs in the latter part of a fund’s ten-year lifecycle. Because fund managers must successfully surpass a minimum profit target or “hurdle rate” (i.e., 8%), the realization of “carried interest” is generally not guaranteed.

Upon receipt of the carried interest, the fund manager gains interest in the fund and pays tax in the same manner as other partners (investors) on their distributive share of the fund’s taxable income. The character of the income included in the manager’s distributive share is the same as the character of the income recognized by the fund.
“...Some have characterized it as an unfair loophole that must be closed. But from where I sit any policy that ensures that capital can flow freely to businesses seeking to grow and create jobs is crucial. And that is why the current tax treatment of carried interest—as a capital gain—is entirely appropriate...Private equity funds buy and sell companies, which no one disputes are capital assets. As a result the tax code makes clear that profits realized from the sale of those assets should flow to the limited and general partners of the fund and be taxed as capital gains.”

—Pam Hendrickson, the Chief Operating Officer of The Riverside Company, a private equity firm, and member of the Small Business Investor Alliance.
Encourage Investments in Small Business through the Tax Code

One way to encourage investors to make capital commitments to small businesses is to reduce the capital gains rate for holding the investment over the long haul. While the capital gains rate can be as high as 23% for the sale of most long-term assets, Congress has recently allowed taxpayers to exclude capital gains income for investments in qualified small business stock.

Long-term capital investments allow businesses to spend on capital projects and job creation. Many venture and growth companies need extra cash to stay competitive and broaden their products into new markets. As investors seek new opportunities to help small businesses grow, it is imperative that Congress continues promoting long-term investments in qualified small businesses. The 1202 capital gains exclusion is a excellent way to continue to encourage risk taking and patient capital.

The qualified small business investment tax incentive has been tucked into the annual tax extenders’ bill for the past few years. Making this provision permanent is very important to provide certainty for investors and to encourage long-term investment and business formation.

Congress should modernize this tax provision to apply to an expanded universe of small business investments. SBIA recommends making these small changes:

1. Modernize the definition of QSB to include all investments consistent with the definition of small business under the Small Business Investment Act of 1958 (as amended). This would simplify eligibility requirements, requiring less paperwork and administrative burdens. Also, it would allow more growth-oriented small businesses to access capital.

2. Clarify that small business stock can include stock acquired upon the exercise of warrants. This would reduce the initial cost of capital for small businesses by adding equity to a debt deal.

3. Allow investors that sell qualified small business stock held over three years to defer recognition of capital gains by reinvesting the sale proceeds in new qualified stock within six months. This would encourage repeat investors to invest in more than one small business.

4. Increase the gross asset test in the Qualified Small Business (QSB) definition from $50 million to $75 million and index for inflation. This update of the definition will keep up with the growth of the economy.
“As my company looks to find portfolio company investment opportunities, the qualified small business investing incentive is particularly appealing to us because it increases the probability this capital will go to eligible small businesses. I’d like to see Congress take the next step and make this provision permanent and expand its usefulness by applying it to warrants. Small business investing certainly deserves this attention.”

—Gayle Hughes, Partner, Merion Investment Partners, a private equity fund in Radnor, Pennsylvania

…imperative that Congress continues promoting long-term investments in qualified small businesses.
SBIA Recommendation:

Attract Foreign Capital in Business Development Companies (BDCs)

SBIA supports making permanent a tax provision that incentivizes and attracts foreign investment in domestic business development companies (BDCs), which are an important source of capital for small and medium size companies.

BACKGROUND OF BDCS:

BDCs are government-regulated investment companies that were created in 1980 by Congress to spur investment in and allow a new source of capital for small and mid-sized businesses. BDCs allow retail investors an opportunity to invest in a portfolio of private small and mid-sized companies by purchasing shares in the BDCs. Most BDCs are publicly traded on national exchanges.

Today, the BDC industry is a $65 billion industry and growing rapidly. There are over 70 active BDCs in the U.S., and the SBIA is the leading advocate for BDCs across the country. BDCs invest debt and equity capital in “middle market” companies, which are mid-sized companies that are in the range of $10 million and $1 billion in gross receipts. The middle market loan industry is a part of the market not being met by traditional lenders such as banks.

For tax purposes, BDCs are structured as Regulated Investment Companies (RICs), which are pass-through taxable entities requiring BDCs to pass through at least 90 percent of their income to shareholders each year.

REASON FOR LEGISLATION:

Section 871 of the U.S. Tax Code inhibits foreign investment in BDCs by requiring 30 percent withholding of any interest to be paid to foreign investors of RICs. Legislation is needed to reduce permanently these taxes, thereby encouraging more foreign investment in BDCs.

Incentivizing foreign capital to invest in BDCs will allow more capital for American job creation and business growth and help the industry mature to reach its full potential. Not only will this encourage foreign investment, it will give BDCs the ability to rely on a more stable flow of investment from abroad, allowing them to pursue more confidently and aggressively their interests without the uncertainty of losing such investment due to a gap of withholding protection. Foreign investors will also be able to ensure that their long term investment plans will not be inhibited by tax barriers.

Legislative History:

On December 31, 2014, the temporary one-year removal of withholding tax on dividend interest payments to foreign investors expired. As such, non-resident aliens are once again subject to a 30% withholding tax, which has the potential to stymie further foreign investment. Congressman Erik Paulsen (R-MN) previously introduced legislation to make permanent the removal of these withholding taxes on foreign investors. This bill, H.R. 4555, introduced on May 1, 2014, in the last session of Congress, was not enacted.
What is Private Equity?

Private Equity consists of funds and the investors in those funds that provide equity and/or debt capital to privately-owned companies (not listed on a stock exchange), or complete a “buyout” transaction of a publicly traded company, taking it private, and delisting its stock from the stock exchange. Under the federal securities laws, only an “accredited” individual or an institutional investor may invest in a private equity fund. Accredited investors are those investors that have over $200,000 in annual income or at least $1 million in net worth, excluding their primary residence. The lifespan of a traditional private equity fund is 10 years. During that time, the capital of the investors in the fund is locked up and returned over time as the investments are paid off. This illiquid structure affords businesses the time required to execute on their long term strategic goals. Private equity funds vary widely, depending on their investment strategy and the financing needs of their businesses. They provide patient and flexible capital, and often specialize in financing and supporting businesses at various stages of growth and maturity, as well as in specific industries and geographies.
The typical private equity fund structure, which mirrors that of a venture capital or SBIC fund, has an investment adviser (often regulated under the Investment Advisers Act by the SEC), and the fund is comprised of the invested capital from the managers of the investment adviser and the outside investors. The fund is generally structured as either a partnership or an LLC, and the fund’s assets and investments are directed by the managers that work for the investment adviser.

Private equity invests for the long term. During market and financial crises, the patient capital of private equity funds can help businesses survive a downturn or economic shock. Small private equity funds do not simply provide capital to small businesses and sit on the sidelines and hope they grow. They are active investors that create value in their investments.

Following the investment, private equity fund managers often work closely with a company’s management team to help accelerate the company’s growth. Fund managers work to improve profitability by developing better products and services, expanding the sales channels, and introducing the portfolio companies to new supply chains. Additionally, fund managers work with the CFOs of its portfolio companies to improve financial operations and IT systems, reduce costs, and streamline financial reporting processes.
Private equity activity is driven by investments in middle market companies, which are firms valued at $25 million to $1 billion. **Since 2009, private equity has invested over $1.6 trillion dollars in thousands of middle market companies.**

**VENTURE CAPITAL FUNDS**

Venture Capital funds are a type of private equity fund focusing investments on early-stage companies, often providing equity or debt financing to startups and small and mid-size firms that have strong growth potential. Venture financing is attractive to new companies that are too small to raise capital in the public market and not credit worthy enough to attain a bank loan or issue debt themselves.
What is an SBIC?

Small Business Investment Companies (SBIC) have a long history of success helping small businesses access long-term, patient capital for growth. For over 50 years, SBICs have been providing capital for American small businesses and the jobs they create. The SBIC program, administered by the SBA, utilizes the talent of experienced private investment fund managers to achieve critical public policy objectives. Fund management teams that meet the SBA’s minimum requirements and successfully complete the application process are able to access leverage up to two times the private capital they raise. These funds then invest in a portfolio of U.S. small businesses, creating jobs, fostering innovation, and fueling economic growth.

HOW DO SBICS WORK?

Private Investors
For the SBIC Program, private investors are critical partners to the U.S. Small Business Administration, supplying necessary capital to be matched by leverage. Private investors include: banks, pension funds, institutional investors, and high net worth individuals.

Small Business Administration (SBA)
The SBA has overseen the SBIC program since its inception in 1958. SBICs pay an annual charge to the SBA to keep leverage at zero subsidy, with no cost to the taxpayer.

Small Business Investment Company (SBIC)
SBICs are managed by highly qualified private equity professionals who have extensive experience investing in small businesses. Each SBIC fund manager meets or exceeds the stringent requirements set by the SBA, including proven investment track record and history of working together as a team.

U.S. Small Businesses
The SBIC program goes a long way to solve the capital constraints of U.S. small businesses. Small businesses use this critical capital to expand facilities, buy equipment, and increase their workforce.
SBIC Debenture Program Total Capital by Fiscal Year

Source: Small Business Administration

Distribution of SBIC Financing Dollars by Industry Reported FY 2009-2013
Total SIBC Financings = $13.5 Billion
Distribution of SBIC Financing Dollars by Geography Reported FY 2009-2013
Total SIBC Financings = $13.5 Billion

East North Central: 11.4%
West South Central: 11.0%
West North Central: 5.2%
Mountain: 7.5%
Pacific: 7.5%
Middle Atlantic: 19.0%
South Atlantic: 11.8%
East South Central: 3.6%
New England: 8.9%
West South Central: 11.0%
What is a BDC?

Business development companies (BDCs) were created as a result of amendments to the Investment Company Act of 1940 (‘40 Act), passed as part of the Small Business Investment Incentive Act of 1980. BDCs are designed to provide loans and management expertise to middle-market businesses. BDCs are structured as a pass-through entity for tax purposes (Registered Investment Company or RIC), register and sell shares in public offerings under the SEC rules, and trade on national exchanges (although not all BDCs are currently traded on a national exchange). As BDCs are registered and public funds, retail investors are eligible to invest in them. BDCs receive the yield of illiquid private equity funds, generally without the illiquidity risk.

BDCs are designed to provide loans and management expertise to small and middle-market businesses.
There are currently over 70 BDCs in existence in the U.S. with over $65 billion in assets. Traditional lenders, such as banks, are facing increased regulatory burdens and unable to invest in BDCs. The BDC percentage of leveraged loans is seen as likely to grow significantly. BDCs, including the amount of capital raised, have grown significantly. The following illustrates the types of investments that BDCs make.

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**Senior Term Loan**
- Secured by 1st lien behind the bank revolver
- 2nd in the capital stack
- Repaid after Senior Revolver
- Traditional banks provide “Senior Revolver loans”

**Unitranche Loans**
- Secured by 1st lien behind the bank revolver
- Repaid after Senior Revolver
- Blended combination of senior/subordinated into one loan with blended interest rate

**Second Lien**
- Secured by 2nd lien behind the bank’s senior debt portion

**Subordinated Debt**
- Secured/unsecured debt
- If secured, it is paid after all Senior debt is repaid (including Second Liens)

**Preferred/Common Stock**
- Equity
- Total loss if company fails, lower value than preferred stock
- High risk/higher return

Source: Jonathan Bock, BDC Analyst, Wells Fargo Securities
SBIA Government Relations Team

SBIA’s Government Relations Team welcomes the opportunity to talk with you about the impact of private equity investment in your state or district. We have a database of thousands of small businesses across the country that have received financing from our member funds. We are eager to work with you to make progress on the SBIA Legislative and Regulatory Agenda.

Brett Palmer  
President

Chris Walters  
Senior Director, Governmental and Regulatory Affairs

Chris Hayes  
Legislative and Regulatory Counsel

SBIA DC Fly-In

Every year, SBIA holds an annual DC Fly-In with the goal of updating Members of Congress and their staff on the SBIA Legislative and Regulatory Agenda. If an SBIA member is in attendance from your Congressional district, the SBIA Government Relations team will set up a meeting with your office.
SBIA Champion of Small Business Investing Award

During the Congressional session, the Small Business Investor Alliance hands out Champion of Small Business Investing Awards to Members of Congress in recognition of their commitment to championing small business investing policies. Several Members of Congress received this award in the 113th Congress including Congressman Blaine Luetkemeyer (R-MO), Congresswoman Carolyn Maloney (D-NY), Congressman David Cicilline (D-RI), Congressman Steve Chabot (R-OH), and Senator Jim Risch (R-ID).