



SBIA Member Update – SBIC Examinations

FROM: SBIA Government Relations Team¹

DATE: December 14, 2016

On December 14, 2016 the Office of Innovation and Investment of the U.S. Small Business Administration (“SBA”) hosted a meeting with SBIC industry lawyers, accountants, and other service providers to meet and ask questions of the SBIC examination group at the SBA. This included all the SBIC examiners working within the program. SBIA organized a group of attendees to this meeting, which met beforehand and developed a list of issues to be discussed. Below is a list of the highlights that came out of the meeting:

Updates on SBA Regulations & Policy

- The SBA identified four rules that they are actively looking to propose or finalize. SBA has a number of rules in various stages of the rulemaking process.
 - **Final Early Stage Fund Rule:** The early stage program was subject to a request for comment initially in March 2015. SBIA provided [comments](#) in Spring 2015 in response. In September 2016, the SBA issued a proposed rule incorporating previous comments, with SBIA providing [further comments](#) on the proposal in October 2016. The final rule is currently being approved by the Office of Management & Budget (OMB) and can be expected to be potentially released early in 2017.
 - **Final Impact Fund Rule:** The Impact SBIC program has existed without a formal regulatory structure since it was created in 2011. In February 2016, SBA released a proposed rule formalizing the Impact SBIC program. SBIA provided [comments](#) on this program in March 2016. The final rule is currently being approved by the Office of Management & Budget (OMB) and can be expected to be potentially released early in 2017.
 - **Final Passive Business Rule:** The passive business rule has gone through multiple iterations in an effort to make it workable for SBICs. Most recently, a new version of the rule was proposed in October 2015. In December 2015, SBIA submitted [comments](#) regarding the proposed revisions. Attached to this update is a copy of how the new rule addresses certain deal-structuring issues. This rule is currently waiting for the SBA Administrator’s signature before it can be issued as a final rule. This may not occur until the new administration.

¹ The law firm of Polsinelli, LLP, an SBIA member, provided assistance in drafting this member update.

- **Proposed Administrative Fee Rule:** On Friday, December 16, 2016, SBA released a proposed rule to increase the licensing and examination fees. SBIA intends to comment on the proposal in February 2017.
- **Proposed Management Fee Technote (Technote 7B):** SBA intends to issue a new Technote on management fees. This will address issues that have developed from the use of the new Model Limited Partnership Agreement. Specifically, this Technote will address accounting for management fees and expenses under the new Model LPA. The Technote will be posted on the SBA website for public comment, and not released for formal notice and comment. The Technote is currently being reviewed by SBA's Office of General Counsel (OGC)

Main Focus Areas for SBIC Examiners in 2017

- The SBA Examiners identified five major focus items for exams in the coming year:
 - 1) Accounting for Management Expenses & SBIC Management Companies
 - 2) Whether TechNote 7(a) Offsets are Computed and Recognized Correctly
 - 3) Whether §107.860 (Application & Closing Fees; Expense Reimbursements; and Breakup Fees) and §107.900 (Management Fees; Board Member Service Fees; and Transaction Fees) are Computed and Applied Correctly
 - 4) Accounting for Cash Received / Prepaid Management Fees
 - 5) Use of Prepayment Restrictions on Loans

Other Updates on SBIC Examinations

- **New Leadership of Office of Examinations:** The SBA has recently promoted Michael Donadieu to be the new Director of the Office of SBIC Examinations, to replace Lourdes Gatell, who has left the agency. Michael began his federal career at the Internal Revenue service in 1987, before joining SBA as a staff accountant in 1991. He held positions as Financial Analyst, Area Chief, and Senior Examiner in the Office of Investment & Innovation prior to being named the Director of Examinations in November 2016. Michael holds a BS degree from Shepherd University, as well as BA and JD degrees from West Virginia University. He holds a CPA (inactive) and is a member of the West Virginia State Bar. Michael was the top examiner in the program, so is very familiar with examination issues impacting SBICs and should be a positive leader of the Office going forward.
- **New Focus on Improving Communications re: Examinations:** SBA intends to focus on improving outside and internal communications on SBIC examinations and examination trends to SBIC licensees going forward. They expressed interest in meeting with industry more often, and communicating national exam priorities to licensees. The meeting of examiners was the first meeting that had occurred in 17 years at the SBA, due to funding constraints.

- **Improving Processes & Technology:** The SBA is making a major push to innovate their exam process in the coming year. In particular, they are looking at implementing a “paperless” exam process. SBIA intends to make this part of our advocacy effort, in particular implementing the use of “virtual data rooms” through outside vendors to promote transparency and accountability in all SBIC processes from licensing and operations to examinations.
- **Focus on Improving Uniformity in Exams:** SBA stated that it was an increased focus to improve uniformity in examinations to ensure all funds are being treated the same through examinations in regard to the regulations. There is also a focus to improve interaction between operations and examinations to improve uniformity.
- **New Schedules 5 & 6 in Examinations:** SBA has implemented two additional Schedules (1-4 previously existed). New Schedules 5 (Reconciliation of Partners Capitalization) & 6 (Financing) will be standard requirements in all future examinations. These were rolled out in the past 30 days without real notice to the industry. SBA claims that this data will only be used in examinations and that this data was previously asked for in a piecemeal fashion during examinations and instead will be asked for up front through the new schedules.
- **Examination/Operations Differences:** SBIA asked about whether an SBIC can rely on documentation from an operations analyst certifying that a particular activity is permissible. SBA responded that if this is something like a prior approval or a waiver, this would likely be taken at face value, however, examinations believes that sometimes many facts are not provided or disclosed to operations, and they will take a closer look. If they disagree, the operations sign-off may not be a permanent safe harbor for SBICs. The clear focus was that SBICs must meticulously document analysis and steps taken when operating in a gray area.
- **Largest Challenges for Examiners:** SBA examiners indicated their largest issue when examining SBICs is the documentation provided surrounding and supporting portfolio company valuations. They also indicated the second most important issue is the lack of preparedness when they arrive for an examination.
- **Escalation/Poor SBIC Examiner Service:** SBA highlighted that if you are not receiving good service as a licensee, these issues should be escalated to the Exam Manager, or to Mike Donadieu, who is the head of SBIC examinations.
- **SEC/SBA Coordination:** SBA and the SEC’s Private Fund Examination Unit have had mutual training and discussions about the expertise in examining private funds. The SBA staff indicated that they did not feel the SEC experience was helpful to them in their examinations because of the SEC focus on investor fraud, and with different standards than at the SBA. They did not believe there was necessarily common ground between the two agencies on these issues.

If you would like further information regarding this Examination Update, please contact Chris Hayes, SBIA’s General Counsel, at chaves@sbia.org or (202) 628-5055.