



VIA Electronic Submission

May 18, 2015

Javier Saade
Associate Administrator
Office of Investment & Innovation
U.S. Small Business Administration
409 Third Street, SW
Washington, DC 20416

Re: SBA Advance Notice of Proposed Rulemaking on Early Stage Small Business Investment Company Initiative: RIN 3245-AG68

Dear Associate Administrator Saade:

On March 18, 2015, the Small Business Administration (“SBA”) issued an advance notice of proposed rulemaking, seeking input and comments on the Early Stage Small Business Investment Company (SBIC) initiative, created in April 2012 (“Proposed Rulemaking”).¹ The Small Business Investor Alliance (SBIA), as the primary advocate of SBICs, appreciates the opportunity to provide comment on the Early Stage program, and highlight where changes could be made to improve the viability of the Early Stage SBIC program and improve the licensing processes for both Early Stage and traditional SBICs.

The SBA has dedicated significant resources in their attempt to fill the capital access gap faced by Early Stage ventures. This is a noble effort. SBIA thanks the SBA for making this effort, for seeking opportunities for improvement, and for seeking public comment on the initiative.

After receiving the Proposed Rulemaking in the Federal Register, SBIA conducted a significant analysis and contacted licensed Early Stage SBIC’s for feedback on the program, including: Greyhawk Capital, LiveOak Ventures, Noro-Moseley Partners and Walden Ventures. SBIA also spoke with a number of the law firms that have represented applicants for licensure in the Early Stage program. While we received mixed reactions from the participants in the program and from the legal advocates for potential licensees, one message that came through was clear – SBA must reform and improve the Early Stage SBIC program, particularly the licensing process. Reforming the licensing process will increase certainty and help with demand for the program, present clear and consistent guidelines and goals for funds to reach in order to receive a license, and ultimately, help minimize the most significant barrier to fund managers seeking to participate in the program – licensing uncertainty. However, reforms to other parts of the program are also needed.

¹ See Small Business Investment Companies – Early Stage, Advanced Notice of Proposed Rulemaking, 80 F.R. 14034-14037 (March 18, 2015).

While the Early Stage SBIC program has significant problems with its current licensing process – the fact that only five funds have been licensed out of 58 applicants makes that abundantly clear² – it is clear that many of the licensing problems with the Innovation Fund SBIC are plaguing the conventional SBIC process too.

SBIA believes that Early Stage businesses are underserved in their access to capital, particularly outside the major financial centers in the Northeast and West Coast. This is critical, as studies have shown that, much like middle market businesses, venture capital availability has a strong link with job creation. According to the Bureau of Labor Statistics, 50 percent of those venture funds go directly toward hiring, as smaller, venture-backed companies create jobs at an above average rate.³

Our comments are broken into two parts: issues unique to the Early Stage program and issues shared with the conventional program. With certain improvements, the SBIC Early Stage program could be re-launched with potentially more success than the current program.

² *Id.* at 14034

³ Guillermo de la Dehesa, *Venture Capital in the United States and Europe*, Group of Thirty, p. 7 (2002), available at: <http://www.group30.org/images/PDF/ReportPDFs/OP65.pdf>.

Issues Unique To the Early Stage Program

Early Stage companies in the United States, particularly those outside the major hubs in the Northeast and the West Coast, experience a significant gap in financing, a gap that an Early Stage SBIC program could help fill. Early Stage investing creates employment faster because venture-stage companies must ramp up quickly and hire new employees as they get started. While a true equity program would be far preferable to address this type of Early Stage investing, a debt program can be adjusted to provide some benefit to this arena.

Early Stage Licensing Must Be Overhauled

The problems with the licensing of Early Stage SBIC program results in both branding and structural problems. In terms of branding, potential applicants will look at the licensing numbers, along with their legal counsel, and assume there is no hope of licensure, and avoid the program. This is already happening. If this program is to continue, it must be reformed and rebranded, and it must establish that the licensing process has been overhauled going forward.

- SBA has high licensing standards and high standards must be maintained.
- SBA should provide clearer guidelines as to what it takes to receive a license for this program, what track record is required, and provide more certainty to applicants as to what fund manager profiles and experience will likely result in licensure.
- SBA should take more actions to promote the program to Early Stage managers, and highlight that only 50% of the investments in these funds must meet the SBA's definition of "Early Stage."
- SBA should allow teams without a track record together, from both the debt and venture sides, to form a team that can execute a hybrid-strategy fund, consistent with both the debt and equity features of this program. Pairing both sides of the equation would still encourage Early Stage investing, while allowing the debenture payments to be met.
- SBA must eliminate the current system of having a "call" for Early Stage applications and move to a rolling application system. Allowing for rolling applications will ensure that when prospective applicants are ready to apply to the program, they can apply rather than having to wait for SBA's window for application. This would also allow for more of a feedback loop for addressing the needs of both the SBA and the fund managers. Current Early Stage managers and their advisers universally agreed that this would improve the program and attract more participants.

Need to Align Early Stage Needs with the SBA Product Offered

A significant barrier to utilization of the SBIC Early Stage program is that the debenture model is not geared toward venture investing, which is based on equity investments that do not generate cash flow until an exit from the investment is realized. Equity investments take much longer to mature and to establish viability.

- Currently, Early Stage SBICs must choose to either make current interest payments on the "current pay" debenture out of an interest reserve made up of their private capital, diminishing the amounts they have available to invest, or they can use an "Early Stage" debenture which deducts all the interest payments up front for the first five years of the fund's life. After polling four of the five existing Early Stage SBIC licensees, SBIA has

learned that none are utilizing the Early Stage debenture to lever the fund, largely due to the unfavorable economics of doing so.

- Another issue decreasing interest in Early Stage SBICs is that these funds generally cannot access the full tier of leverage. As Early Stage companies are viewed to have a higher risk, Early Stage SBICs are required to maintain an interest reserve account containing a sufficient balance to cover interest and charges on its outstanding SBIC debentures.⁴ As a result of the interest reserve requirement, if a fund took the full tier of leverage available, and was unable to keep a high enough reserve, there is a significant chance of falling out of compliance. This problem does not exist in the traditional SBIC program, and results in most Early Stage SBICs only taking ½ a tier of leverage, dramatically limiting the attractiveness of the program. SBA should look at the interest reserve and adjust it accordingly to prevent funds from feeling apprehensive about drawing the full tier of leverage.
- SBA should remove the 2016 sunset of the Early Stage program. Without certainty, fund managers are not sure the leverage will be available beyond 2016.
- SBA should examine allowing non-levered, equity oriented SBICs funds to convert to Early Stage levered funds. This could have several benefits. First, it would allow equity investors the ability to invest the way they normally would without the costs of buying a leverage commitment or setting aside money for interest payments. Second, it would let them use leverage to “double down” on their winning investments instead of taking leverage on all of their investments, some of which are likely to fail. This would also delay equity dilution by allowing businesses to continue to grow in both size and valuation before needing to raise more equity. Finally, this could do a better job of matching the life of the fund with the length of the debentures, which are currently out of cycle for early stage investing. It should be noted that there is a mixed view of this concept in the industry because while the funds could double down on their winners, there would need to be safeguards put in place to ensure that the fund is not doubling down on questionable portfolio companies in a long shot “Hail Mary” attempt to rescue the fund. Creating this option would require further technical discussions with the SBIC industry via the SBIA.

Interest Reserve Requirements Should Be Adjusted to Make the Program Functional

Early Stage funds are required to set aside an interest reserve to ensure the payments on the SBIC debentures are made during the first five years after the debenture is originated. The reserve is a necessary component of the program for SBA’s protection, but the risk of the interest reserve should be evaluated to ensure it is tailored appropriately. A number of the Early Stage funds highlighted the onerous requirements of the interest reserve, and the fact that it ties up significant private capital. SBA should reconsider modifying the interest reserve requirement in a way that does not increase the risk of the program.

⁴ 13 C.F.R. §107.1180; 13 C.F.R. §107.1181

The SBA Should Explore New Operational Improvements in the Early Stage SBIC program.

A number of funds we spoke with indicated that, given the dramatic difference in venture investing from the other types of investments done by traditional SBIC funds, it was difficult or a futile exercise to deal with certain SBIC regulations. Respondents made the following observations and suggestions:

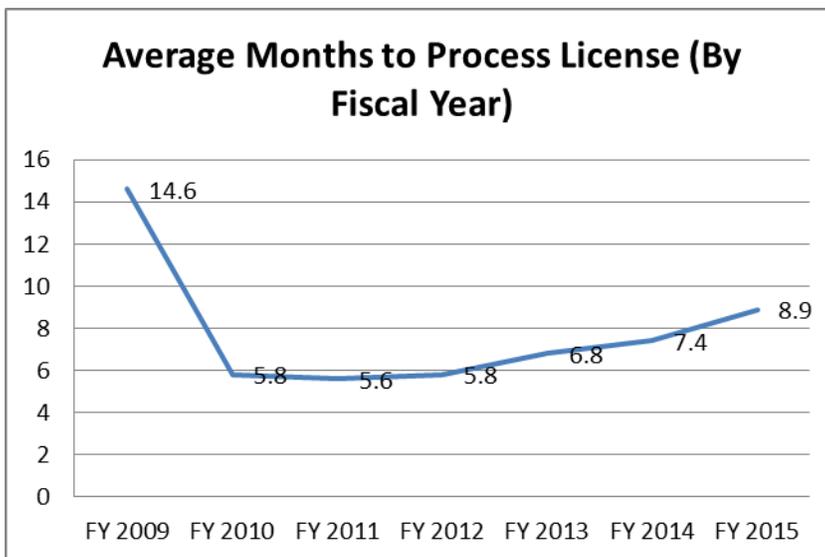
- Funds are required to do forecasting on their portfolio companies. Some funds felt that this requirement was futile and a waste of time given the smaller and less certain future of these venture investments.
- Creating an operating plan for every year of the fund was not a good use of time for the fund managers, when they could be out investing and doing deals.
- The examination of Early Stage funds was conducted by an examiner less familiar with these types of funds. SBA needs to train their SBIC examiners on venture investing and Early Stage SBICs, or have a dedicated examiner for these funds who is familiar with how these investments are made.
- SBA's cost of money rules may not work for venture investing. Funds that engage in Early Stage investing, as opposed to traditional SBIC funds, commonly take convertible notes instead of warrants when they make an investment in an Early Stage company. To adequately compensate for the higher risk, these convertible notes often pay a very high rate once they are converted, which violates the SBIC cost of money rules. In these instances, a business may choose to not use an Early Stage SBIC because it puts them at a disadvantage in the marketplace. SBA should take steps to allow a waiver from the cost of money rules for Early Stage SBICs to keep them more competitive in their financings.
- Given that the J curve is inherently longer for Early Stage investments, SBA should review how it handles Capital Impairment for Early Stage SBICs. SBA should provide more flexibility to reflect the different timing of the J curve for this program.
- SBA should examine raising the dollar limit, not ratio limit, on the leverage. Raising the limit to 75 or 100 million dollars would make the program more attractive to a wider range of funds. It would also allow the costs of licensing and SBA compliance to be a smaller portion of the fund's cost structure.

Licensing Reforms Needed to Address Both Early Stage and Conventional SBICs

SBIA believes that the current licensing process is broken for both Early Stage SBICs and traditional SBICs, requiring a significant overhaul. . Given that the “once a year” application process, the problems with licensing is particularly acute for applicants to the Early Stage Program. The entire multi-tiered, redundant licensing process should be consolidated and streamlined to provide fairness, transparency and efficiency.

There is a lack of clarity around licensing expectations by the SBA, which is magnified by the unique characteristics of the Early Stage program. The lack of clarity harms applicants by wasting their time and money. This is particularly true for the Early Stage program where a 90% failure rate is prima facie evidence that SBA did not know what they wanted or failed to communicate what the qualifications were.

The lengthy approval times and associated lack of information result in the program being less attractive to applicants and successful funds. As this chart below illustrates, the average time to earn a license has about nearly doubled. This is despite fewer applications and the numbers skewing lower by the co-mingling of micro, non-levered, impact funds. While SBIA applauds the SBA for the improvements they made to licensing times in the FY 2009-2010 time frame, something has meaningfully changed for the worse. Decreasing applications and increasing times indicate a problem.



In order to ensure the long-term success of the program, SBA must take steps to address the following issues affecting all licenses, both Early Stage and Conventional:

- 1) **Improve Clarity & Expectations Prior to Licensing:** Improve the clarity and expectations regarding what it actually takes to receive a license, in order to provide more guidance to SBIC applicants.
- 2) **Remove Redundant Licensing Processes:** Eliminate the staffing bifurcation of the licensing and Management Assessment Questionnaire (“MAQ”) processes.
- 3) **Make the Green Light Letter Meaningful:** Create a meaningful “green-light” letter by setting a clear “roadmap” to licensure - including listing the specific amount of private capital that must be raised in the letter - in order to prevent the rampant “moving of the goalposts” after the letter is issued;
- 4) **Establish An Application Tracking System With Timelines & Benchmarks:** Create an internal tracking system with timelines for each step in the process to ensure accountability from licensing team members and Office of General Counsel. Make this tracking system available to applicants to track the progress on their license application.
- 5) **Allocate Resources Effectively:** Institute streamlined licensing requirements for successful second-time SBIC licensees and non-levered SBIC funds.

Improve Clarity and Expectations Prior to Licensure

For many SBIC applicants, the licensing process appears to be a black box, with no clear guidance for what the standards and timing will be for licensure. This is particularly true with the Early Stage program. The current way these fund managers and potential applicants are able to approach the program is through their lawyers and accountants that understand the nuances and personalities behind how the licensing process operates. As a result, many fund managers decide not to move forward within the program because of the uncertainty over licensing, along with the high cost of pursuing a license. The specialized lawyers who operate in the SBIC licensing space have been burned by unclear standards which discourage all but the most vanilla of funds from applying. Losing the confidence of the legal community specialized in the SBIC program is exceptionally damaging to the program. This lack of licensing clarity results in less diversity of both fund managers and fund strategy in the program. Making solid improvements and dedicating SBA staff attention to the clarity and expectations of these fund manager applicants can result in more qualified SBICs being licensed, and the attraction and retention of qualified fund managers.

SBIA recommends making certain changes to the licensing process to improve clarity and transparency. While updating the standard operating procedure for the SBIC licensing process for funds (“Licensing SOP”) was a positive step, SBA should ensure that every applicant receives a copy of the SOP and is made aware of its existence.⁵ As this Licensing SOP was never sent out for public comment and feedback, SBIA encourages the SBA to re-release their newly released Licensing SOP for public comment and seek industry input on this document to ensure that it is effectively representing what steps SBA takes in the licensing process, as well as where improvements could be made.

⁵ *Processing Applications for SBIC Licenses*, SOP 10 04 1, U.S. Small Business Administration, Office of Investment & Innovation (August 6, 2014), available at: https://www.sba.gov/sites/default/files/sops/SOP10-04-1_0.pdf

There are changes in transparency, process and clarity that should be made. As this SOP was never sent out for public comment and feedback, SBIA encourages the SBA to re-release their newly released Licensing SOP for public comment and seek industry input on this document to ensure that it is effectively representing what steps SBA takes in the licensing process, as well as where improvements could be made. SBA should also follow the SOP.

Remove Redundant Licensing Processes

The current “Investment Committee” should be disbanded and replaced by the “Divisional SBIC Licensing Committee” which should conduct the “green light” interview and issue the “green light” letter. Given that the Investment and Divisional Committees are made up of substantially the same people, this would allow the SBA to eliminate the Divisional SBIC Licensing Committee meeting at the tail end of the Licensing Application process. As long as conditions are met by the applicants in the “green light” letter, the license should go directly to the Agency Committee for final approval, thereby eliminating the need to arrange the scheduling and sign-off by substantially the same people at two different times. This approach would eliminate one Committee meeting, while still ensuring the same level of vetting is not compromised. It is critical that the Agency Committee give clear written guidance to the licensing staff and applicants to ensure fairness and consistency.

There is no need for bifurcation in the MAQ and Licensing processes or staffing. To promote efficiency and timeliness in licensing, continuity of licensing staff should be established to review the MAQ, present the MAQ and associated analysis to the Divisional SBIC Licensing Committee (as the Investment Committee should be eliminated), and process the licensing application through Agency approval from start to finish. Additionally, for repeat licensees the operations analyst should formally be brought into the process. Having continuity in analysts throughout the process eliminates the need for a new analyst to get up to speed on a particular fund, its managers, and the MAQ contents once a “green light” letter is issued. This approach will streamline the licensing process, creating efficiency and utilize institutional knowledge.

Make the Green Light Letter Meaningful

SBIA members and their legal advocates have significant concerns with the MAQ and “green light” letter process. Currently, the “green light” letter indicates that funds have been favorably received by the “Investment Committee” and can proceed with their Licensing Application after they have raised sufficient private capital. Unfortunately, the current letter fails to state anything meaningful or binding. SBIA believes that the “green light” letter should specifically indicate the clear metrics for licensure, for example, the minimum amount of private capital to be raised.

In addition to “green light” letter certainty, the SBA should take steps to inform those applicants who did not make it through the Investment Committee, in detail, what concerns the SBA had with their MAQ and presentation, and what, if anything, could be changed to allow the Investment Committee to move forward with their application, based on the facts in the record.

Establish an Application Tracking System with Timing and Benchmarks

SBA should allow applicants to track the movement and progress of their application. In addition to sunlight on the process through the system, this would promote accountability in the licensing unit, ensuring that applications that are moving too slowly through the process would be recognized and addressed. SBA already has an application tracking system in existence, and should make this publicly available to applicants and their legal counsel to track applications. Further, the SBA should establish certain benchmarks and timelines for each stage of licensing and review after the licensing application is received. This will promote accountability and efficiency within the Licensing Unit and ensure applications are being moved expeditiously forward.

SBA's informational technology challenges frustrate both the applicants and the SBA. SBA should consider the use of "off the shelf" technologies such as data rooms to increase their operational efficiency, provide easier document exchange, and to increase transparency.

Allocate Resources More Effectively By Focusing On New Funds, Not Proven SBICs

The SBA should take steps to create an expedited application approach for established fund managers who have performed well in the SBIC program. Established fund managers who have performed well in the SBIC program, should not experience extended licensing times. Second-time funds with substantially the same investment team, a successful investment record through the life of their prior fund, and a similar fund investment strategy should be licensed in weeks. New background checks, capital certificates, and legal documents are all that should be required. These applications should be "fast-tracked" through the process, as long as performance does not deteriorate. This will allow the Licensing Unit to focus its energies on new applications from first-time SBIC fund applicants.

SBIA should utilize the operations analysts in the licensing process of second-time funds. Having the operations analyst familiar with the fund involved in second-time licensing would be extremely helpful in explaining the fund's history, process, strategy, portfolio, and track record. The current operations analyst also is an effective reference to the fund's identity, having considerable interaction with the fund's principals and management. This is extremely helpful institutional knowledge that would help streamline the licensing process from a time perspective, and adds significant value to those in Licensing Division who do not have day-to-day familiarity with the fund.

SBIA appreciates the opportunity to provide feedback to the SBA on how to ensure more capital gets into the hands of America's small businesses. We are happy to answer any questions you may have.

Sincerely,
Brett Palmer
President
Small Business Investor Alliance

cc: Carol Fendler, Acting Deputy Associate Administrator, OII
Theresa Jamerson, Senior Policy Advisor, OII