

## SBIA SUMMARY: SBIC Diversification and Growth – Proposed Rulemaking

This is a top-line summary of the U.S. Small Business Administration’s (SBA) proposal to revise regulations governing the Small Business Investment Company (SBIC) program. SBA published its proposal on October 19, and interested parties have until December 19 to submit written comments.

The proposal includes numerous elements and questions from SBA requesting stakeholder feedback. In particular, SBA proposes: (1) creation of a new equity-focused SBIC license (“Accrual SBIC”) that would include a new debenture instrument (“Accrual Debenture”) where there are no interest or principal payments due in the first ten years; (2) permit under certain conditions SBIC investments in re-lenders and re-investors (e.g., fund-of-funds) in underserved areas or led by under-represented individuals; and (3) various amendments to the SBIC program’s rules governing licensing, operations and examinations intended to help increase the program’s accessibility to new funds and participation diversity including to prioritize new SBIC licenses in under-licensed states pursuant to the *Spurring Business in Communities Act of 2017* (PL 115-333).

As a reminder, the SBA’s proposal is not final and additional changes are expected during the rulemaking process in response to stakeholder comments and recommendations.

*SBIA reminds readers that this summary is for informational purposes only. It is not legal advice. Please consult your firm’s legal and accounting professionals regarding any matters with the proposed rulemaking that may affect your firm and its portfolio companies. SBIA reserves the right to revise this summary as new information and analyses become available.*

<u>TOPIC and CFR Section</u>	<u>SUMMARY</u>	<u>COMMENTS</u>
<b>Accrual Debenture/Accrual SBIC [9-10]. Sec. 107.50</b>	Proposed new license (“ <b>Accrual SBIC</b> ”) for equity-strategy funds that (a) invest at least 75%/total financings in Equity Capital Investments; (b) own not more than 50%/portfolio companies at initial financing; (c) elect at licensing to issue Accrual Debentures. SBA will aggregate total	



<b><u>TOPIC and CFR</u></b> <b><u>Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
	<p>principal leverage plus ten years of accrued interest to determine total leverage per Accrual SBIC subject to current limits (\$175M/\$350M).</p> <p><b>“Accrual Debenture”</b> is 10-year debt instrument issued at face value that would accrue interest over its ten-year term to better align with the cash flows of long-term, equity-oriented funds. It also includes a federal guarantee of principal and interest payments if Accrual SBIC is unable to pay, with additional 5-year roll-over option subject to SBA approval.</p>	
<p><b>SBIC Program Definitions</b> [11-16] Sec. 107.50</p>	<p>SBA proposes material amendments to existing terms and important new terms including:</p> <p><b>“Associate.”</b> Raise the ownership ceiling from 33% to 50% of Licensee’s private capital for entity Institutional Investors before being considered an associate of the Licensee.</p> <p><b>“Equity Capital Investments”</b> Includes preferred stock, LP interests, certain subordinated debt, and warrants. (<i>SBA seeks input for any additional changes to this term.</i>)</p> <p><b>“Leveraged Licensee”</b> and <b>“Non-leveraged Licensee.”</b> Distinguish between these two forms of licensees to ensure that SBA applies the appropriate level of scrutiny under the SBIC program.</p> <p><b>“State”</b> and <b>“Under-licensed State.”</b> The <i>former</i> includes all 50 states, the District of Columbia, and the five territories. The <i>latter</i> defines a State where the number of operating Licensees per capital is less than the national median.</p>	
<p><b>Management Ownership Diversity</b> [16] Sec. 107.150</p>	<p>SBA proposes to <u>expand the exception</u> to the diversification ownership requirement (<i>i.e.</i>, management of a Licensee must be sufficiently unaffiliated from the sources/ Regulatory Capital) to include <i>non-profit entities</i> that may own 70% or more/Licensee’s regulatory capital.</p>	



<b><u>TOPIC and CFR</u></b> <b><u>Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
<b>Minimum Capital Requirements/ Licensees</b> [17] Sec. 107.210	SBA proposes to codify statutory intent (PL 115-333) to <u>expand the exception</u> from the \$5M Regulatory Capital minimum and give SBA discretion based on “good cause” ( <i>e.g.</i> , licensee is headquartered in an Under-licensed State) to approve licenses for SBIC applicants that otherwise meet the program’s licensing standards yet only have \$3M but show a viable business plan to reach \$5M. Such licensees would be eligible for one tier/leverage until achieving the \$5M level.	
<b>License Application Fee/Form</b> [18-21] Sec. 107.300	<p>(<i>proposed new policies</i>) (1) give licensing process priority for SBIC applicants from Under-licensed States; (2) SBA to approve total leverage commitments/life of SBIC Licensee <u>at licensing</u> to limit commitment requests and future uncertainty; (3) important for licensees to raise expected capital before submitting license application for Final Review.</p> <p>SBA proposes to revise the Initial and Final Licensing Fee tables to lower barriers for new funds.</p> <p>(<i>proposed new fee</i>) <u>Application Resubmission fee</u> (\$10,000) for any applicant that previously withdrew or otherwise was not approved. Fee would be in addition to the Initial and Final licensing fee schedule.</p>	
<b>Evaluation of Licensee Applicants</b> [21] Sec. 107.305	<p>SBA proposes to expand current applicant qualification elements to include: (i) <i>industry operational experience</i>, and (ii) <i>experience managing a regulated business</i>.</p> <p>Also, when <u>evaluating applicant’s investment strategy</u>, SBA to seek inclusion/strategy in the applicant’s business plan, which also helps underscore the underlying importance of the SBIC program’s statutory public purposes.</p>	
<b>Leverage Portfolio Diversity (LPD)</b> [22] Sec. 107.320	Proposal to <u>reserve SBA authority</u> to maintain LPD in approving leverage commitments <u>to maximize the program’s economic impact to underserved small business concerns</u> while also managing risk to the program.	



<b><u>TOPIC and CFR Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
<b>Licensee Adoption of Approved Valuation Policy</b> [22-23] Sec. 107.503	<p>(proposed new) SBA proposes to allow Non-leveraged Funds (including Licensees that fully repaid leverage and seek no further leverage) to adopt GAAP valuation policy.</p> <p>(proposed new) SBA proposes to require quarterly, not semi-annual, valuation reporting by Leveraged Licensees.</p>	<i>SBA seeks stakeholder input about current practice requiring leveraged licensees to provide both GAAP and non-GAAP valuations.</i>
<b>Office and Equipment Requirements</b> [23] Sec. 107.504	SBA to amend equipment requirements to allow for reasonable changes/technology without need for future amendment to the regulations.	
<b>Prior Approval/3dP debt of Leveraged Licensees</b> [24-27] Sec. 107.550	SBA proposes to allow Licensees secure a “ <b>Qualified Line of Credit</b> ” exempt from SBA pre-approval, but that meets strict minimum qualifications regarding its <u>size</u> ( $\leq 20\%$ /total unfunded binding commitments/Institutional Investors), <u>term</u> ( $\leq 12$ months with renewal option), <u>holder</u> (federal regulated financial institution) and <u>borrowing purposes</u> (operating liquidity/portco financing; secured only by unfunded regulatory capital equal to 100%/amount borrowed plus 90-days/interest; repaid within 90 days, and fully paid off during fiscal year/Licensee).	
<b>Restriction on 3dP Debt of Issuers of Participating Securities</b> [27] Sec. 107.570	SBA to strike this regulation	
<b>Distributions and Reductions in Regulatory Capital</b> [27-30] Sec. 107.585	<p>SBA proposes to establish separate distribution requirements based on the following categories/SBICs:</p> <p>(1) <u>Non-leveraged</u>. Allow distributions without prior SBA approval <i>provided</i>: (i) Fund retains “sufficient regulatory capital to meet minimum capital needs under 107.210 unless the amounts are in accord with a Wind-down plan.</p> <p>(2) <u>Leveraged Funds (before 10.1.2023) and BDC-owned SBICs (not “Accrual SBICs”).</u> No change to current distribution</p>	



<b><u>TOPIC and CFR Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
	<p>rules, but with some new elements including retained earnings available for distribution (READ) allowed if no material adverse changes to portfolio would ensue. Must report to SBA any reduction in regulatory capital within 30 days (on an updated Capital Certificate).</p> <p>(3) <u>Leveraged Funds (after 10.1.2023)</u>, excluding <u>BDCs and Accrual SBICs</u>. SBA proposes new waterfall structure to repay SBA/outstanding balance of leverage on a <u>pro rata basis</u> with private investors. See rulemaking at 30 for “waterfall” details. (“SBA is concerned that private investors have at least the same risk/loss as SBA.”)</p>	
<b>Active Operations by Licensee</b> [31] Sec. 107.590	Proposed label change from “Wind-up Plan” to <i>Wind-Down Plan</i> .	<i>No material changes to current policy</i>
<b>Requirement to Obtain Information from Portfolio Concerns</b> [31] Sec. 107.620		<i>SBA to propose amendments to information collections/Financings after the effective date of this rulemaking (next phase)</i>
<b>Filing Financial Statements with SBA</b> ( <i>Form 468</i> ) [31] Sec. 107.630	<p>SBA proposes to require Licensees to file Form 468 annually within 90 days following end of Licensee’s fiscal year, consistent with Sec. 107.650.</p> <p>SBA also proposes new data collection metrics/portfolio companies regarding <i>net jobs created</i> and <i>total jobs created/retained</i>.</p> <p>Additionally, SBA proposes to add to Form 468 <i>fund management contact</i> and, on an optional basis, <i>demographic information/fund management</i>.</p>	
<b>Portfolio Financing</b> ( <i>Form 1031</i> ) [32] Sec. 107.640	( <i>new</i> ) SBA proposes that Licensees make <u>quarterly submissions</u> , with Licensees to report financings within 30 calendar days of the calendar year quarter following the closing/financing.	
<b>Reporting Portfolio Valuations</b> [32] Sec. 107.650	( <i>new</i> ) Only <u>Leveraged Licensees</u> to report quarterly, within 45 calendar days/quarter close.	<u>See also</u> <b>Filing Financial Statements with SBA</b> ( <i>Form 468</i> ) above



<b><u>TOPIC and CFR Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
	All other Licensees to report annually.	
<b>Other Required Items/Licensee Filing with SBA [33]</b> Sec. 107.660	(new) SBA proposes to specify valuation data items to file, and to submit to SBA any report provided to the Licensee's private investors within 30 days of such provision.	
<b>Examination Fees [33]</b> Sec. 107.692	(new) SBA proposes new fee schedules separated between <u>Leveraged</u> and <u>Non-leveraged Licensees</u> to better address risk and additional monitoring required of the former. Non-leveraged Licensees with over \$50 million/assets will be assessed an additional \$20,000 with their fee.	
<b>Small Businesses Ineligible for Financing [34]</b> Sec. 107.720	SBA proposes to <u>expand the exception</u> from ineligible SBIC financings to allow SBIC equity investments in "underserved" re-lenders and re-investors (e.g., "fund-of-funds and non-bank lenders) that make investments solely in Small Business Concerns.	SBA does not define "underserved" noting that "by more broadly defining 'underserved,' it can more quickly adapt to the changing markets by clarifying what constitutes 'underserved' through policy notices and increase its economic impact to underserved communities." (Rulemaking at __)  SBA also believes expanding this exception will help fill the pipeline of emerging fund managers.
<b>Financings that Trigger Conflict of Interest [35]</b> Sec. 107.730	SBA proposes a new "safe harbor"/Conflict of Interest for the financing of a portfolio company by an Associate: <i>when an <u>outside third-party</u> participates in the equity financing of the Licensee's portfolio company at the same time and on same terms as the SBIC, and the third party's share represents a significant portion.</i>	
<b>Minimum Duration/Term of Financing [36]</b> Sec. 107.830	SBA seeks comments on whether 107.830(c)(2) should be modified to clarify that <i>pro rata</i> distributions of prepayments in unitranche or multi-lender transactions <u>do not require</u> prior SBA written approval.  SBA is also considering offering a new "safe harbor" from pre-payment restrictions for SAFEs and convertible notes.	



<b><u>TOPIC and CFR Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
<b>Control of Small Business by Licensee</b> [36] Sec. 107.865	<p>SBA proposes that Accrual SBICs should limit their ownership of portfolio companies at initial financing to less than 50 percent but that this limit <u>would not apply</u> to the financings of a re-lender or re-investor (defined at 107.720(a)(2)) to not discourage investments by SBICs into those entities that are important to help underserved areas.</p> <p><i>SBA recognizes, however, that the SBIC licensee may need to own a higher share of its Small Business Concerns <u>after</u> the initial investment to protect its interests.</i></p>	
<b>Non-leveraged Licensees-Exceptions to Regulations</b> [37] Sec. 107.1000	Ministerial amendments proposed	
<b>Leverage Fees and Annual Charges</b> [38] Sec. 107.1130	SBA proposes an Annual Charge floor at <u>50 basis points</u> (0.5%)	
<b>Maximum Amount of Leverage</b> [39] Sec. 107.1150	SBA proposes various conforming amendments in this section to acknowledge the Accrual Debenture program and to update the text to reflect that Section 301(d) for Specialized SBICs was repealed.	
<b>Filing Quarterly Financial Statements</b> [39] Sec. 107.1220	SBA proposes conforming amendments to align this section with Sec. 107.650.	
<b>Licensee Capital Impairment</b> [40] Sec. 107.1830	<p>SBA proposes amendments to delete obsolete provisions, and also proposes new language requiring SBA to calculate an SBIC's "capital impairment percentage" (CIP) quarterly and notice Licensees of any capital impairment. Current regulations give SBA flexibility to calculate CIP at any time.</p> <p><i>Secs. 107.1840 and 107.1845 outline how SBA computes CIP and SBA "proposes to make related changes" to these sections later per Sec. 107.1030. No specific amendments proposed.</i></p>	



<b><u>TOPIC and CFR Section</u></b>	<b><u>SUMMARY</u></b>	<b><u>COMMENTS</u></b>
<b>Enhanced Monitoring</b> [41] Sec. 107.1850	<p><i>(new)</i> SBA proposes that SBICs that are not performing at level sufficient for SBA will be placed on “Enhanced Monitoring” status:</p> <p>An SBIC would fall under EM status for a series of actions including: (i) falls in bottom quartile performance relative to SBIC’s stated benchmark/four (4) consecutive quarters; and (ii) reported failures/SBIC program policies and procedures. While on EM status, an SBIC would be required to file Form 1031 “on a more frequent basis, and upon request, conduct portfolio review meetings with the SBA.”</p> <p>SBA would end EM status when the actions are resolved by the Licensee.</p>	
<b>Small Business Size Regulations – Determining Affiliation</b> [41] Sec. 121.103	<p>SBA proposes to expand the current exemption under the Affiliation rule to include private funds exempt from SEC registration under Sec. 3(c)(7) of the 1940 Act (<i>i.e.</i>, qualified purchasers).</p> <p><i>(The current exception covers 3(c)(1) private funds and Traditional Investment Companies defined under the 1940 Act.)</i></p>	