NASBIC
America's Small Business Partners

Statement
of
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Before The

United States Senate
Committee on Small Business & Entrepreneurship

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Madam Chair, Senator Kerry, members of the Committee:

Thank you for the opportunity to appear before you today to give NASBIC's views about the Administration's FY 2005 budget proposal as the same relates to the SBIC program. NASBIC is the only professional association dedicated to representing the interests of all licensed SBICs. We hope our views are helpful to the Committee as it considers the issues we will address today.

By way of background, I am President of North Atlantic Capital in Portland, ME, and also serve as Chairman of NASBIC. North Atlantic Capital manages two Participating Security SBICs focused on small businesses requiring capital in the $2 million to $5 million range. We concentrate on businesses located in the Northeast. A good example of one of our investments is Diamond Phoenix Corporation of Lewiston, ME, a leader in providing integrated material handling equipment, software, and control technology for order fulfillment systems. We first invested in the company in 1998 and have invested a total of $4.0 million over five years. I am pleased to say that our investments have been instrumental in helping the company grow to its current size—120 employees—and to weather the recent recession. Diamond Phoenix has eight offices in eight different states as well as an office in London, England.

Before turning to the budget, I would like to stress some of the statistics believe highlight the importance of the SBIC program to U.S. small businesses and the nation's economy.

- Since its beginning in 1958, the SBIC program has provided $40 billion of long-term debt and equity capital to 95,000 small U.S. companies, with $2.47 billion invested in 2,610 small businesses in FY 2003 alone. The number of U.S. small businesses receiving SBIC financing in FY 2003 was up 21% from the 1,979 that received SBIC financing in FY 2002.

- U.S. small businesses financed by SBICs in FY 2003 employed approximately 347,000 individuals—an average of 133 employees per company—at the time they received the SBIC financing. The median number of employees in SBIC-financed companies was 30.

- Companies less than three years old received 43% of all investments.

- SBICs play an important role in states not generally served by venture capital firms. Of the 2,610 U.S. small businesses that received FY 2003 SBIC financing, 1,112 (43%) were located in areas designated as Low- and Moderate Income (LMI) areas by the government. Those companies received $556 million (23%) of the total $2.47 billion in SBIC investments.

- SBICs are playing a vital role in our current national economic recovery. SBA reports that SBICs accounted for 59% of all venture capital investments, by number of investments for the period January through September 2003. For comparison, in 1997 it was just 38%.

- At present, there are 436 SBICs operating in 45 states, the District of Columbia, and Puerto Rico. SBICs hold $21.5 billion in capital resources—up 7.5% from $20.1 billion at year-end FY 2002—a significant increase given the contraction in other sources of venture capital. Of the total, $12.2 billion is private capital and $9.3 billion is SBA-guaranteed capital or commitments. In FY 2003, SBA licensed 36 new SBICs with $743 million in private capital.

- Over the past three years (FY 2001-2003) hard-pressed small U.S. manufacturing companies have received $2.6 billion (27%) of the $9.6 billion in total SBIC investments for the period.

- Many well-known U.S. companies received early financing from SBICs, including America Online, Apple Computer, Callaway Golf, Intel, Staples, Quiznos, Federal Express, Outback Steakhouse, Costco, and Vermont Teddy Bear. Eight of the top 100 fastest-growing U.S. companies in 2003 received SBIC financing (*Fortune*, September 1, 2003), as did six of the top 100 "Hot Growth Companies for 2003" featured in *BusinessWeek* (June 9, 2003) and 10 of the 100 "Top Information Technology Companies" (*BusinessWeek*, June 23, 2003).

NASBIC supports the Administration's budget proposal for the Debenture SBIC program.

If approved by Congress, the proposal would make $3.0 billion in Debenture leverage authority available in FY 2005 at a zero subsidy rate. A zero subsidy rate has been in effect since the start of FY 2000 for the Debenture program. In order to maintain the rate in FY 2005, an increase of 16 basis points is required in the annual interest paid by Debenture SBICs pursuant to §303(b) of the Small Business Investment Act (SBIA). NASBIC supports that very small increase. Based on the most recent pricing of Debenture leverage, that of September 2003, the practical impact of the increase would be negligible—raising the likely interest paid for FY 2005 leverage from approximately 5.73% per annum to approximately 5.746% per annum. The two tenths of one percent increase in the annual cost of leverage will have no impact of any consequence on either Debenture SBICs or the small businesses they finance. No legislative change to the SBIA is required to implement the Administration's proposal. We ask the Committee to support the Administration's FY 2005 proposal for the Debenture program.

In addition to urging the Committee's support for the Administration's budget proposal for the Debenture program, we applaud and urge the Committee's continued support for congressional action to remove Debenture indebtedness from the class of "Acquisition Indebtedness" that creates Unrelated Business Taxable Income (UBTI) for tax-exempt investors who would, but for UBTI, invest in Debenture SBICs. Due to the strong support and hard work of Senators Snowe, Kerry, and Bond, the legislative solution to the problem is pending as part of the Manufacturing section of S. 1637, the "Jumpstart Our Business Strength ('JOBS') Act." When enacted, the provision will eliminate a major fundraising impediment in the Debenture program and we expect to see substantial growth in the program and in its effectiveness to help small businesses in need of debt financing. As I know the Committee appreciates, debt capital has been in very short supply during the recession and continues to be difficult to obtain.

NASBIC supports the proposed $4.0 billion in Participating Security leverage authority for FY 2005, but strongly opposes the program restructuring proposed by the Administration.

The Participating Security program is critical to the success of the SBIC program as a whole. Designed to stimulate the flow of scarce equity capital to America's small businesses, it has done that very successfully. In FY 1995, its first full year of operation, the program saw Participating Security SBICs make $110 million in equity investments, just 8.8% of all SBIC investments that year. For the period FY 2002 through January 23, 2004—a critical economic period as U.S. business fought to survive the recession—Participating Security funds invested $2.8 billion, a full 47% of the $6.0 billion in all SBIC investments made during the period. In the current FY 2004, through the same January 23, Participating Security SBICs have accounted for 55% of all

SBIC investments. Twenty-six (72%) of the 36 new SBICs licensed by SBA in FY 2003 were Participating Security funds. Clearly, the program is providing the equity capital Congress intended when it created the program its 1992 amendment of the Small Business Investment Act.

Of perhaps greater importance, Participating Security SBICs have proven to be a much more reliable source of equity capital for small business than all other sources during the recession we have just endured. The high water mark for all venture capital investments in the U.S. was the year 2000, with investments totaling $103 billion according to Thomson Venture Economics. In 2003, total venture capital investments fell to $18 billion—a decline of 83% during the period of recession. In contrast, the $1.1 billion in Participating Security investments made in FY 2003 were 77% of their FY 2000 total—a decline of just 23% compared to the 83% decline for the entire industry. That performance in a very difficult economic period is testimony to the importance of the Participating Security program to U.S. small businesses.

The Administration's budget proposal projects $2.0 billion in potential losses in the Participating Security program. That number includes both realized losses and estimated future losses. Thus, as a starting point, it is uncertain whether or not the final figure will total $2.0 billion. Of greater importance is the context in which the losses have occurred. Again referencing Venture Economics, the quarter that ended September 30, 2003 was the 11th consecutive quarter for which venture capital funds sustained losses for the preceding 12-month period—"by far the worst streak in the industry's history." That history dates to the start of the SBIC program in 1958, a period of 45 years. Of significant relevance to SBA's estimate of losses is the fact that the Participating Security program saw $4.3 billion (57%) of its total of $7.5 billion in investments to date made in the 5-year period that ended September 30, 2000—the period just preceding the economic collapse from which America is just beginning to recover. It should surprise no one that the Participating Security program will realize losses associated with investments during that period. NASBIC has mentioned the likely losses often during the past three years. Those losses will accrue to private investors as well as SBA, and it will be years before the true nature of the losses will be known.

Faced with its estimate of losses in the Participating Security program, the Administration has determined that the structural model in place since the start of the program is flawed. Whether or not this is true is open to question since 57% of investments to date were made in perhaps the worst period of at least the last 45 years in which to make equity investments. However, given the projections made by OMB in its subsidy calculations, it is unlikely that any agreement might be reached between the industry—both management teams and private investors—and the Administration that would see the current structure retained with minor adjustments that would satisfy both sides.

In order to achieve a "zero" subsidy rate, the Administration proposes several major changes in the Participating Security program for funds licensed after September 30, 2004.

1. The budget anticipates congressional enactment of the legislation proposed by SBA last July. That legislation would keep the current structure—with all its negative elements—while changing SBA's share of the profits in profitable Participating Security funds to one-half of the percent of total capital represented by SBA leverage—an effective 300% increase in SBA's profit share. NASBIC opposed the proposal when it was made in July.

2. The budget narrative states that a substantial increase in fees—in addition to passage of the July proposal—is required to keep the subsidy rate at "zero." Although the legislative proposal regarding fees has yet to be filed, we understand that the proposal will include the following:

   a. an increase in the leverage "commitment" fee from 1.0% to 1.5% (the leverage "draw" fee would remain at 2.0%);

   b. an increase in what is now the 1.454% prioritized payment rate dedicated to SBA pursuant to §303(g)(2) of the Small Business Investment Act to 3.85%; and

   c. a radical change in the nature of the §303(g)(2) fee, a change that would make the full 3.85% per annum rate on outstanding leverage payable annually to SBA irrespective of profitability of the Participating Security SBIC in question.

We believe the Administration's proposal was made in a good faith effort to address the structural problems the Administration believes has led to its current losses. We want to stress the fact that we enjoy an excellent working relationship with the Administration, even when we disagree. Unfortunately, we are now at a point of substantial disagreement. The proposed economic structure would all but destroy private sector support for the Participating Security program. This is so for several reasons.

1. First, the proposal would reintroduce an annual, current coupon, "interest" charge for leverage. Since the law requires that all Participating Security leverage must be invested in equity securities, the change would reintroduce the mismatched cash flows that saw the original SBIC program plagued with losses in the 1980s, the very result of which gave birth to the current program. Either the law would have to be changed to permit debt investments—unlikely given the express purpose of the program—or Participating Security funds would have to use a substantial amount of their capital for interest payments instead of investments—a purpose again at odds with legislative intent.

2. Second, the proposal would reintroduce Unrelated Business Taxable Income (UBTI) issues for Participating Security funds that raise private capital from tax-exempt institutional investors, the very investors SBA and SBIC management teams want to attract to the program. Funds that create UBTI for their institutional investors find it almost impossible to raise money from these investors. It is a major issue since tax-exempt institutional investors control approximately 65% of the capital in the U.S. available for investment in venture capital funds.

3. Finally, even if we were to assume that the 3.85% rate were to apply only to the extent of profits—perhaps unreasonable given the Administration's estimates—the proposal would leave all existing program negatives (e.g., capital impairment and restricted operations regulations) in place while substantially increasing the risk that an investor in a Participating Security SBIC would do less well than by investing in a non-SBIC fund.

   For example, assume a Participating Security fund with leverage to private capital ratio of 2:1 and a 6.0% prioritized payment rate attributable to the pool securities sold to raise the actual leverage. Both are reasonable assumptions for modeling purposes. Applying the proposed changes, the “new” program’s fund IRR (internal rate of return) “hurdle” rate—the fund IRR rate at which an investor’s net return is the same whether invested in an non-SBIC fund or a 2:1 leveraged SBIC—would increase from approximately 12.0% to 18.3%. That is an increase of 53%. At an 18.3% fund IRR, private investors would net approximately 11.3% whether invested in an SBIC or not. Above the “hurdle,” a private investor in an SBIC would do better than an investor in a non-SBIC fund, but only marginally so at gross return rates that likely to apply at least for the near future. At a gross fund IRR of 20% an SBIC investor’s net return would be approximately 14.6% versus 12.7% for an investor in a non-SBIC fund. At a fund IRR of 25%—a rate slightly above the 20-year average for all venture capital funds—the respective net returns would be approximately 21.5% versus 18%. For virtually all private investors, this substantially reduced potential for return enhancement would not be worth assumption of the substantially increased risk of worse returns (attributable to SBA’s preferred status) that they would realize if they invested in a Participating Security fund that performed below the increased “hurdle” rate. The structure proposed by the Administration is simply one that cannot be made to work for knowledgeable private investors.

Before turning to NASBIC’s proposed solution to the existing problem, we would like to highlight one additional problem with the Administration’s proposal for the Participating Security program. The proposal leaves unanswered the question of what happens to existing Participating Security SBICs that may require leverage from commitments to be issued after September 30, 2004. The logical extension of the Administration’s budget submission is that any leverage authority for years following FY 2004 that will be required to support Participating Security funds licensed before October 1, 2004—funds whose economic structures cannot be adjusted in line with the proposal for contract sanctity reasons—will have a positive subsidy rate and require an appropriation. However, no mention is made of the very real potential problem and no appropriation request is included for FY 2005. It may be that the Administration assumes that 5-year commitments purchased prior to October 1, 2004 will solve the problem. However, that will not be the case for many funds, especially those licensed in fiscal years 2002, 2003, and 2004. Is there a solution to the problem short of attaining appropriations for any relevant year? Perhaps. We would like to explore with the Committee the possibility of a legislative extension of the effective dates of commitments issued prior to October 1, 2004. If that is not possible, some other solution must be identified.

NASBIC proposes a new Participating Security program structure that meets the requirements of all program stakeholders.

If the current structure for the Participating Security program will not work for the Administration and the Administration’s proposed structure will not work for SBIC management teams and their private investors, is there a structure that will meet the needs of all stakeholders? We believe there is. Attached to this testimony is a policy paper that outlines NASBIC’s proposal. It is the same paper that we shared with this Committee, the Senate Committee on Small Business and Entrepreneurship, and the Administration in January. Following its submission, we forwarded to Committee staff a proposed draft of legislation that we believe would successfully implement that policy.

Simply stated, NASBIC's proposal would create a Participating Security structure within which SBA would enjoy 100% of its pro rata share of the profits of any profitable fund. The structure would create, at least in economic returns, a structure identical to that used in the private venture capital world. If such an economic structure been in place since the inception of the program, we believe SBA would be substantially better off financially than it is today—a fact that can be confirmed by SBA upon inquiry by this Committee. While it is true that SBA would have to surrender its preferred position with respect to private investors if our proposal were accepted, that preferred position has been of little economic comfort to SBA over the last ten years. That is precisely why it has found it necessary to propose the changes that are unacceptable to management teams and private investors. Those private investors include major banks who are members of the Small Business Investment Alliance, banks that have made substantial investments in SBICs in the past and would continue to support the program under the structure we have proposed. These banks are strong supporters of the community development role played by SBICs across the country.

The crucial question for the Administration will be how to project cost or gain to the government if NASBIC's proposal is accepted. Regarding that question, the 20-year net returns to investors in venture capital funds with economic structures such as we suggest have averaged, according to Venture Economics data, approximately 16% per year. The cost to SBA to guarantee interest for the pools of securities sold to raise Participating Security leverage has averaged 6.7% per year since the first pool was sold in 1995. Interest rates have been at very low levels for the past two years. Excluding the pool rates of those years yields an average rate of 7.0%. Thus, if Participating Security SBICs perform to industry averages, a program structured as we have proposed should make money for the taxpayers over and above the gain for the economy related to the economic activity of the small businesses receiving the equity investments. Under any reasonable analysis, the subsidy rate in a Participating Security program structured as we suggest should be zero—even if return data are discounted somewhat because SBICs invest in a wider variety of businesses that are more geographically dispersed, than non-SBIC funds.

Implementation of NASBIC's proposal would produce an additional benefit for SBA: reduced workload. SBA Investment Division personnel are severely taxed due to the complexity of the current program and the multiple subjective decision points that must be addressed for each Participating Security fund. There is no counterpart to that level of activity or substitution of judgment in the non-SBIC portion of the venture capital industry. Implementation of the NASBIC proposal would allow Investment Division personnel to focus primarily on the critical licensing process and, of equal importance, on compliance by operating SBICs with all investment requirements. The highest possible level of performance in both areas is critical to the success of the program in meeting its intended purposes. At a time when all organizations are called upon to "do more with less," this point is an important consideration.

Will private investors support the program without the possibility of enhanced returns? The answer for the largest majority of investors in venture capital funds—bank and non-bank institutional investors—is "yes." The large majority of those investors avoid the SBIC program because of the substantial number of negative elements in the program that are discussed in our policy paper. Institutional investors seek reasonable returns for the asset classes they invest in, venture capital being one of the classes. The complexity of the current program, the preferences accorded SBA, and the other negatives associated with the program, keep the large majority of institutional investors on the SBIC sidelines. The structure we have proposed will be seen as a great improvement by this class of investors so critical to the ultimate success of the program.

Will talented fund management teams be attracted to the SBIC program if the structure proposed by NASBIC is accepted? Again, the answer is "yes." Notwithstanding the fact that institutional investors will find the structure acceptable, the universe of private capital from which SBIC management teams might draw will always be substantially smaller than the total universe of private capital dedicated to venture capital. That is so because SBICs can invest only in U.S. small businesses that meet the size and operational limits prescribed by the government. Thus, the government, by its guarantee, would serve as the creator of a substantial pool of capital from which qualified teams would be able to draw to achieve the fund sizes required to sustain operations if they want to invest in the types of opportunities dictated by the government.

In conclusion, thank you once again for the opportunity to appear today to give our views on the Administration's FY 2005 as the same pertains to the SBIC program. We look forward to working with the Committee this year to make certain the SBIC program, particularly a restructured Participating Security program, continues to meet the needs of all its stakeholders—especially the U.S. small businesses it is designed to serve.

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Restructuring The SBA Participating Security Program

A. Summary

This paper discusses issues relevant to a possible restructuring of SBA's Participating Security (PS) program—created by Congress to increase the amount of equity capital invested in U.S. small businesses that meet size and operational requirements defined by the government. The program began in FY 1994, and the goal-oriented results through FY 2003 are impressive:

- More than $4.7 billion in private capital raised by the 221 privately managed PS funds.
- More than $7.4 billion invested by PS funds in U.S. small businesses during the period.

Notwithstanding its impressive start, the program's future is in doubt. SBA will lose substantial amounts associated with its guarantee of leverage for PS funds unable to generate profits sufficient to return that money. The 1997-2000 period was one of great increase in PS licensing and investment that was followed by a major collapse of the U.S. economy. Business failures and plummeting values of those that survived have made it all but inevitable that SBA will suffer substantial losses associated with investments made by PS funds during that period. In this regard, SBA is no different than virtually all investors making investments during the period.

OMB has used SBA's experience of the past ten years to change assumptions in the PS subsidy model that estimates how much the government might be expected to lose in the future. Not surprisingly, the model now predicts substantial future loses if the current economic structure of the PS program remains unchanged. While modeling based on results from such a short period, particularly one as abnormally volatile as the 1998-2001 period, is suspect at best, OMB has shown no inclination to change its opinion. A substantial increase in the subsidy rate would require a substantial—and likely impossible to secure—congressional appropriation to support the program at an effective level. Failure to secure the appropriation would reduce the PS program to a marginal program that would have virtually no impact on U.S. small businesses.

Industry is not opposed to an economic restructuring of the PS program. However, it cannot agree to a simple increase in SBA's of profits in profitable funds. Increasing SBA's profits without addressing program elements that are objectionable to private investors and management teams would yield the same negative result as trying to attain a major appropriation to support estimated program losses. The negatives elements are SBA preferences and debt-oriented credit restrictions in what is intended to be an equity investment program. The provisions do not protect SBA effectively and alienate the very private investors and management teams that SBA wants to attract.

A restructured PS program that eliminates these negative elements and sees SBA become, in economic terms, a pro rata investor in PS funds—an investor entitled to its full share of the profits of each fund it invests in—will best serve the interests of both government and industry. It will ensure a zero subsidy rate, the approval of the largest majority of private investors, and the availability of talented professional management teams crucial to the success of the program. NASBIC urges the Administration and Congress to support this restructuring approach.

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B. Current Status Of The Participating Security Program

1. Section 102 of the Small Business Investment Act (SBIA) provides the policy behind the SBIC program, including the PS program:

   > "It is declared to be the policy of congress and the purpose of the Act to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply: Provided, however, that this policy shall be carried out in such manner as to insure the maximum participation of private financing sources."

2. The SBIA does not indicate what financial result the government should realize in its running of the SBIC program. The only admonition is found in §303(e), the section dealing with "Capital Impairment." It provides that before advancing leverage to an SBIC, SBA should determine that doing so would not "create or otherwise contribute to an unreasonable risk of default or loss to the Federal Government."

3. Working with SBA, OMB sets the government's subsidy rate for the program. These annual calculations produce results that dictate how much must be placed in "reserve" to pay for projected out-year losses associated with leverage issued under any given year's authority. If the required reserve cannot be met by projected fees, profit shares, and subsidy "buy-down" prioritized payments paid by PS SBICs, Congress must appropriate the difference if it wishes to continue the program.

4. Based on current losses in the PS program, if no changes are made in the program's structure, OMB will project substantial losses for SBA's guarantee of any leverage to be issued in FY 2005 and thereafter. Although this may not be justified based on long-term historical returns to LPs in the venture industry, OMB is unlikely to be challenged successfully by either Congress or the industry with respect to its assumptions.

5. Given the above, the FY 2005 PS budget might be submitted in one of two ways. The likely way would see the budget propose to make substantial leverage (e.g., $4.0 billion) available in FY 2005 at no cost to the government (a "zero" subsidy rate)—with the caveat that the budget assumes and is predicated upon passage of proposed legislation either already submitted (or to be submitted) to Congress by the Administration. The most likely reference will be to the legislative proposal made in July of 2003.

6. If restructuring legislation is not passed, projected losses will be accounted for with a positive subsidy rate, requiring an appropriation to support the amount of leverage authority desired. The original subsidy rate for the program was 9%. At that rate, $4.0 billion in authority (the FY'04 authority) would require a $360 million appropriation. Assuming that the "subsidy buy-down" prioritized payment rate (which did not exist in

1994) would make up a portion of the requirement, a subsidy rate of something less than might be likely. However, even a 5% rate would require an appropriation of $200 million for $4.0 billion in leverage authority.

7. Any appropriation above $44 million—the high water mark that supported SBIC program leverage in FY'95—would likely be impossible to secure given the current budget environment, especially if no appropriation is requested by the Administration. Securing half that amount might be possible, although still difficult. Assuming a $40 million to $20 million appropriation range and a subsidy rate range between 5% and 10%, PS leverage availability in FY'05 might be anywhere from $200 million on the low side to $800 million on the high side. The current demand is estimated at $1.3 billion per year. The substantial shortfall would all but eliminate SBA's ability to issue five-year leverage commitments and leverage rationing would likely be inevitable. The program would continue, but would be marginalized. Support for the program by knowledgeable investors and talented management teams would evaporate.

C. Current Structural Elements Of The Participating Security Program.

1. Investment and Geographic Focus Requirements. The government imposes restrictions on the types and sizes of companies in which PS funds can invest. The government also takes into account the need for venture capital in the areas of investment focus stipulated by PS fund license applicants in deciding whether or not to grant a license. These foundation blocks will not change in any restructuring of the program.

2. Leverage Commitment and Draw Fees. Totaling 3.5% at present, all commitment and draw fees (with the exception of the 0.5% underwriting fee included in the total) are paid directly to the government. The fees are among the SBA cash flows used to predict future SBA losses in the program. With respect to private investors, they equate to preferred returns for SBA.

3. Leverage Pool Prioritized Payments. These contingent preferred payments (SBA's right to them dependent on an SBIC's profitability) are intended to reimburse SBA for the interest it has advanced to pay interest to investors purchasing interests in the pools of securities sold to raise the leverage drawn by the particular SBIC involved. The payments are preferred payments to SBA vis-à-vis private investors.

4. SBA-Dedicated Prioritized Payments. These SBA preferred payments, again made only if and when an SBIC becomes profitable, are based on variable rates set annually by Congress at the request of SBA / OMB. Like leverage commitment and draw fees, their purpose is to off-set predicted losses associated with the failure of SBICs to repay leverage principal and/or leverage pool prioritized payments.

5. A Reduced and Variable Profit Share For SBA. In return for investment restrictions, preferred returns, and debt-oriented credit risks discussed below, SBA receives a reduced, variable profit share from profitable PS funds. SBA's profit share is calculated by

reference to both an applicable 10-year Treasury bond rate and maximum leverage ratio—a formula that, for modeling purposes, is generally accepted to yield an approximate 9% SBA profit at a 2:1 leverage ratio.

6. Complex Distribution Rules. The distribution rules are designed to regulate the return of SBA's prioritized return (in profitable SBICs), capital (SBA leverage and private capital), and profits. The distribution rules are complex and alien to investors accustomed to investing in non-SBIC venture capital funds.

7. Conditional SBA Commitments. A statutory provision in the SBIA requires SBA to conduct what amounts to a credit evaluation before advancing any leverage, irrespective of the fact that an SBIC may have already paid for a commitment. Under this authority, SBA may dishonor its commitments based on its unilateral determination that advancement of additional funds would increase risk of loss to the government, notwithstanding the fact that advancement of the amounts would be required to implement the full business plan approved by SBA in the licensing process. Thus, all SBA commitments are, in a legal sense, conditional. Private investor commitments, required to secure the PS license, are unconditional.

8. Capital Impairment Regulations. By reference to the capital impairment section of the SBIA to its general obligation to protect the interests of the taxpayers, SBA has adopted capital impairment regulations that permit it to restrict or shut down the operation of a fund by restricting its ability to make any additional investments (even with private capital) and, at SBA's option, to call remaining private capital for the sole purpose of repaying outstanding leverage. Private investors are particularly upset by these rights. While they understand and accept the risk of loss if the capital is put to its intended purpose—investment in small businesses—they are adamantly opposed to having their capital paid directly to SBA.

9. Liquidation Preference. Once an SBIC has been moved to "liquidation" status, which may be based on either regulatory violations or degree of capital impairment, SBA enjoys a preference vis-à-vis private LPs with respect to outstanding leverage and any earned but unpaid prioritized payments.

10. Absolute Control of Significant LP Rights. Absent SBA approval, private LPs in SBICs have no right to take any action on significant issues (e.g., management change, "no-fault divorce," etc.) generally within their province in non-SBIC funds. Non-SBIC funds generally provide for LP action in certain areas by vote of a super majority of LPs in the fund. Experienced LPs are very uncomfortable with any one LP holding a dominant position in a fund. That is even more so when the LP is the government.

D. The Best Alternative For Restructuring the Participating Security Program

1. Any restructuring should address each of the following policy imperatives:

   (a) The program should stimulate investment in U.S. small businesses to the greatest extent possible during times of scarce capital availability.

   (b) The program should accomplish its mission at the least possible cost to the government.

   (c) The program should be attractive to the largest possible percentage of knowledgeable private investors.

   (d) The program should be attractive to the largest possible percentage of high quality venture capital fund management professionals.

   (e) The program should not distort private market dynamics any more than required to meet the objectives of the program.

2. The structural alternative that best meets all policy requirements would see SBA:

   (a) surrender its rights listed in §§2 through 9 of Paragraph C;

   (b) agree to a reasonable dilution of its voting "power" within the LP structure to the extent required by the "market" (defined as representative institutional investors); and

   (c) retain 100% of its pro rata economic interest in the fund.

3. Under this structure, SBA and private LPs would share profits and losses on a pro rata basis. Other than investment and geographic restrictions, a PS fund would be managed in almost all respects like non-SBIC venture capital counterparts in the private sector.

4. From the government's perspective, consideration of future losses should be eliminated so long as the government invested in SBICs on a regular basis. The average net return to private LPs in venture capital funds has been approximately 16% over the past 20 years according to Venture Economics. Even if discounted by some factor, returns to the government would still be positive over any reasonably projected period of time.

5. From the perspective of private investors, the only issue of importance would become whether the PS fund management team had the skills and business plan likely to produce standard returns for the asset class. There would be no distortion of investment decisions driven by the possibility of enhanced returns due to structural reasons alone. PS funds would still represent one of the best opportunities for investors to receive returns from investments in growing small businesses. The non-SBIC segment of the private equity industry has focused predominantly on larger investments in larger companies. SBICs would be of particular interest to those state pension funds and other institutional funds willing to invest in some venture capital funds that agree to invest in underserved markets. The current negative elements generally keep these investors on the sideline.

6. Finally, from the perspective of professional management teams required to actually "drive" the program, SBA would, for the first time, represent the possibility of securing "normal" capital that might satisfy up to two thirds of the amount required to reach the fund size required to start and sustain investment operations. To put the importance of this fact in perspective, many (if not most) institutional investors do not want their investment to constitute more than 10% of any venture capital fund. This fact would make the SBIC program very attractive to talented teams trying to raise capital during times when private capital is scarce—such as the present time—and at least very worthy of consideration during other times.

7. It is true that the very fact that the "government is involved" might make the program less attractive to management teams during times when private capital available for investment in venture capital funds is plentiful. However, that fact would make the program directly responsive to the policy articulated in the SBIA: a program "to stimulate and supplement the flow of private equity capital … which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply…."

8. In view of the above, NASBIC urges the Administration to support a restructuring of the Participating Security SBIC program that would see SBA become a "regular" Limited Partner in the PS funds to the degree of investment committed to in the licensing process.

E. SBA's Pending Proposal Will Not Meet The Policy Objectives For The PS Program

1. In July 2003, SBA proposed a restructuring of the PS program that would increase the share of profits to which it is entitled by approximately 300%, but in all other respects would leave the program unchanged.

2. Although the potential for enhancement of private LP would remain, the potential would be greatly reduced from that of the current structure. Thus, the risk / reward balance would change dramatically with a 300% increase in SBA's profits and no corresponding reduction of complexity and / or private LP risk related to negative elements listed in Section C. This is particularly so given that many experts believe that average gross returns for venture capital funds may be no greater than the current SBIC "hurdle rate" of approximately 12% for the next decade.

3. SBA's proposal will not achieve the goal articulated in the SBIA or the other important policy considerations listed above. It retains all the unpopular complexity and unquantifiable risk elements of the current structure while reducing potential private investor returns. Adoption of the proposal would severely limit the pool of venture capital management professionals interested managing a PS SBIC. It would also limit the pool of likely investors to those who either did not understand the risks involved or who were attracted only by the potential for an enhanced return no matter how long the odds. Neither result would be good for the either the PS program—or for the U.S. small businesses the program is designed to serve.