

Overview of the SBIC Program

For more than 50 years, the federal government has provided capital to privately owned investment firms, using funds loaned at favorable rates and guaranteed by the U.S. government, through the Small Business Investment Company Program run by the U.S. Small Business Administration (SBA). The SBA makes capital available to privately owned and managed for-profit investment funds (known as SBICs) created for the purpose of offering equity and debt capital to small businesses in the United States. The following is a brief summary of the SBIC program and the process to apply for an SBIC license. This article is by no means exhaustive, and fund managers should consult with legal counsel to determine if they should and how to apply for an SBIC license.

The Two SBIC Funding Programs

There are two separate types of capital granted to licensed SBICs under the SBIC program:

Debenture Securities—Ongoing

Started in 1958, the SBA provides private licenses to investment funds with loans as leverage to supplement their private capital. The loans are guaranteed by the U.S. government and have current, payable interest, so the debenture SBICs typically invest in income-producing, mature small businesses. The SBA continues to issue new leverage commitments under this program, and the debenture program was amended and enhanced by the 2009 American Recovery and Reinvestment Act.

Participating Securities—Terminated in 2004

Starting in 1994 and terminating as of September 30, 2004, the SBA provided capital to SBICs by purchasing preferred equity interests, similar to preferred stock or income bonds, called “participating securities.” The capital invested in the preferred equity interests had first priority over any distributions from the SBIC fund up to a capped preference rate payable only to the extent profits were available. Due to significant losses suffered by the SBA in this program, it has been discontinued except with respect to any existing commitments.

Basics of the SBIC Debenture Program

An SBIC can receive up to \$150 million in federal money for a single fund or \$225 million for multiple funds operated by one manager. SBIC Debentures have a term of 10 years with

semiannual interest payments and a lump-sum payment of the principal at maturity. An SBIC may leverage up to three times the amount of its private capital, although most funds are generally approved to leverage no more than two times the level of their private capital. No fund may leverage more than a specified amount, which is adjusted based on increases to the Consumer Price Index. Once committed to an SBIC, the leverage may be drawn down over the entire four- to five-year commitment period.

What Types of Funds Participate?

The Debenture Securities program is primarily utilized by mezzanine or venture debt funds rather than equity investing funds. This is primarily due to two factors: (i) the necessity of such funds to generate cash flow to service the required semiannual interest payments on the loans from the SBA, and (ii) common contractual restrictions on equity funds prohibiting borrowing in order to minimize risk from leverage and avoid generating unrelated business taxable income.

Structuring for an SBIC Fund

Because of the restrictions on capital loaned through the SBIC program and the uncertain timing of applying for participation in the program as summarized below, fund managers often set up the SBIC fund as a subsidiary of a main fund. In this structure the main fund supplies the required private capital to the SBIC fund on an as-needed basis for investments otherwise contemplated by the main fund but that qualify for funding under the SBIC program. In this way, additional capital in the main fund can be free for use in making other investments that do not fall within the criteria of the SBIC program, and the licensing and application process can occur without significant impact on the formation of the main fund. Fund managers can maintain their flexibility but use the SBIC program as a supplement to increase fund size and leveraged returns in qualifying investments.

Restrictions on Investments by an SBIC Fund

The SBIC license limits the type of investments qualifying funds may make with the loaned capital in the following ways:

1. SBICs are required to invest in small businesses in either debt or equity (or a combination of the two). “Small businesses” are generally defined as companies (including any subsidiaries, parent companies, and affiliates) with a net worth of \$18 million or less and an average after-tax net income of \$6 million or less for the last two years.
2. Further, 25% of investments must be directed to “smaller enterprises,” defined as entities whose net worth is less than \$6 million and whose average after-tax income for the two prior years is less than \$2 million.
3. A maximum of 10% of an SBIC’s total capital may be invested in a single small company unless the SBA approves a larger investment.
4. SBICs are permitted to control small businesses for a maximum of seven years, absent SBA approval to manage them for a longer term.

5. SBICs may not invest in other SBICs, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than 51% of their assets and employees in the United States, passive or casual businesses, companies using the proceeds to acquire farmland, and companies whose primary business activity is contrary to the public interest.

The Application Process and Requirements to Become an SBIC

The process to become an SBIC will generally take four to five months from the initial filing of documents to the issuance of a license. The process has two stages: program development and licensing.

Program Development

In this stage, the fund submits a Management Assessment Questionnaire (MAQ) to the SBA to demonstrate that it meets the minimum requirements of (i) \$5 million in private capital investment, (ii) a qualified management team, and (iii) “adequate profitability and financial soundness” if the fund’s operations are successful. If the SBA determines that the fund meets these requirements, it schedules an interview with management for a final assessment. If the final assessment is positive, the SBA will invite the fund to start the second stage of the application process.

Licensing

In this stage, the fund resubmits the MAQ with any updated information and pays a \$15,000 filing fee. If the application is approved, the paperwork is sent for approval by the Office of Inspector General, a licensing analyst, a legal review team, the Investment Division Licensing Committee, and the Agency Licensing Committee. If the fund receives the approval of these different departments, the complete application is sent to the SBA Administrator, whose final approval is required before the license is issued.

For further information on the specific steps involved in each stage of the process, please refer to the SBA website at <http://www.sba.gov>.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

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Morgan Lewis has one of the nation’s largest private investment fund practices and is ranked the Second Most Active Law Firm in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2009).

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