2013

Early Stage SBICs: A New Source of Capital for Private Investors, Equity for Start-Ups, and Possible Volcker Rule Exemption for Banks

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Early Stage SBICs: A New Source of Capital for Private Investors, Equity for Start-Ups, and Possible Volcker Rule Exemption for Banks

I. INTRODUCTION

On May 1, 2012, the Small Business Administration (SBA) issued a Call in the Federal Register inviting fund managers to apply for licensing as Early Stage Small Business Investment Companies (Early Stage SBIC). This solicitation marked the beginning of the SBA’s most recent endeavor into venture capital investment. President Obama’s 2011 “Start-Up America” Initiative approved the SBA to lend $1 billion to private investment funds that qualify as Early Stage SBICs.


2. SBICs are private, long-term investment funds authorized by the SBA to supplement their reserves of private capital with government-borrowed capital, which usually comes in the form of government-backed debt securities (debenture leverage). In exchange for the relatively inexpensive capital and regulatory exemption benefits for certain investors, SBICs must lend and invest only in qualifying small businesses. Early Stage SBICs are a new, specialty subset of SBICs allowed to supplement their reserves of private capital with a new type of government-backed debt security (discount debenture leverage), whose required interest repayments are deferred to encourage the private funds to invest equity in risky, not-yet-profitable small business start-ups. See generally Michael B. Staebler, An Overview of the Small Business Investment Company Program, PEPPER HAMILTON LLP, 2-6 (Jan. 3, 2011) [hereinafter Staebler I], available at http://c.ymcdn.com/sites/www.sbia.org/resource/resmgr/Files/Pepper_Hamilton_SBIC_Ove rvie.pdf; Early Stage Call 2012, supra note 1, at 25775 (noting general application rules and lending guidelines for Early Stage SBICs).


4. Specific requirements and details for fund managers interested in applying for Early Stage SBIC designation are readily available in the SBA’s template Limited Partnership Agreement, including the general stipulation that the funds must be organized as limited partnerships (LPs), a requirement that stands in contrast with older Participating Securities SBICs, which could choose any corporate or partnership organization structure applicants found most preferable. See SMALL BUS. ADMIN., MODEL EARLY STAGE SBIC LIMITED PARTNERSHIP AGREEMENT—VERSION 2.1 (2012) [hereinafter LIMITED PARTNERSHIP AGREEMENT].
over the next five years. An Early Stage SBIC, after receiving SBA leverage, will in turn invest its mixture of private and SBA-provided capital in early stage small businesses in need of seed money.

This new program may indeed provide access to "long-term, more patient capital" that would otherwise be out of reach for small businesses, but some find it disconcertingly similar to the SBA's previously unsuccessful foray into early stage equity investment—the Participating Securities Small Business Investment Company program (Participating Securities SBIC). The SBA ran that program for ten years before discontinuing its licensing in 2004 and subsequently cutting its funding in 2008. From 1994 until 2008, the SBA provided

5. Early Stage Call 2012, supra note 1, at 25775.
6. 13 C.F.R. § 107.50 (2012) "Early Stage SBIC means a Section 301(c) Partnership Licensee, licensed pursuant to § 107.310 of this part, in which at least 50 percent of all Loans and Investments (in dollars) must be made to Small Businesses that are "early stage" companies at the time of the Licensee's initial Financing (see also § 107.1810(f)(11)). For the purposes of this definition, an "early stage" company is one that has never achieved positive cash flow from operations in any fiscal year." Id.
7. SBA leverage in SBICs can generally take the form of either debt or equity, but Early Stage SBICs may only receive leverage in the form of debt. The SBA is not trying to participate in the profits of investment funds as it did with the Participating Securities program. LIMITED PARTNERSHIP AGREEMENT, supra note 4, at 2 ("Leverage means financial assistance provided to a Licensee by SBA, either through the purchase or guaranty of a Licensee's Debentures or Participating Securities, or the purchase of a Licensee's Preferred Securities, and any other SBA financial assistance evidenced by a security of the Licensee."); Russell Garland, An Older, Wiser SBA Makes New Run at Early-Stage VC, VENTURE CAPITAL DISPATCH, WALL ST. J. BLOG (June 11, 2012, 8:03 PM) http://blogs.wsj.com/venturecapital/2012/06/11/an-older-wiser-sba-makes-new-run-at-earystage-vc/ (noting that this new attempt at supporting small business start-ups will only consist of limited leverage).
8. Early Stage SBICs are generally free to chose the debt and equity instruments used to invest in or lend to qualifying small businesses. LIMITED PARTNERSHIP AGREEMENT, supra note 4, at 12 ("Subject to Section 2.01(a), [an Early Stage SBIC] may make, manage, own and supervise investments of every kind and character in conducting its business as a small business investment company.").
10. Garland, supra note 7 (quoting Sean Greene, the associate administration for investment at the SBA).
13. INV. DIV., SMALL BUS. ADMIN., SBIC PROGRAM ANNUAL REPORT FY 2012
$10.3 billion in guaranteed leverage to Participating Securities SBICs, resulting in a total loss of $2.4 billion for the program.\textsuperscript{14} As of June 30, 2012, the SBA continues to have open guarantees for $1.68 billion in outstanding unpaid principal.\textsuperscript{15} Ultimately the program proved unsustainable, and government-backed equity investments temporarily lost favor in the Administration.\textsuperscript{16}

In 2011, having slowed the losses of the Participating Securities SBIC program\textsuperscript{17} and in reaction to the recent economic slowdown, the SBA reconsidered the option.\textsuperscript{18} Sean Greene, the SBA's Associate Administrator for Investment, recognized: "It would have been easier to say the [Participating Securities SBIC] program failed, let's head for the hills and never go there again, but there is need [for equity financing of early stage small businesses]."\textsuperscript{19} The SBA estimates that over the last five years the annual unmet need for small business equity financing has totaled roughly $60 billion.\textsuperscript{20} The "Start-Up America" Initiative authorized the SBA to address this perceived shortage, particularly for those in need of $1 to $4 million dollars in equity investment and for those distant from venture capital centers located primarily on the east

\textsuperscript{14} Id.
\textsuperscript{16} See Staebler I, supra note 2, at 4.
\textsuperscript{19} Garland, supra note 7 (quoting Greene, associate administrator of investment at the SBA).
As the SBA invites a second round of funds to apply for designation as Early Stage SBICs, three important questions arise. First, will the SBA succeed in its current attempt to implement a sustainable and effective program for equity investments in early stage small businesses? Second, will this new program serve as a useful and attractive resource for start-up investors seeking additional capital? And third, can Early Stage SBICs serve as a useful tool for banks and bank holding companies seeking to avoid Volcker Rule restrictions on proprietary trading?

This Note answers each of these questions in the affirmative and continues in Part II by providing an overview of SBIC lending options. Part III describes the regulatory structure of Early Stage SBIC lending. Part IV summarizes the advantages of Early Stage SBICs to early stage small businesses seeking equity, investors seeking additional capital, and banks or other financial institutions seeking new investment strategies for exemption from Volcker Rule restrictions on proprietary trading. Finally, Part V offers a brief concluding analysis.

II. SBIC LENDING OPTIONS

A. Overview of SBIC Lending

The SBA currently offers three options within its SBIC lending platform—the Debenture SBIC, the Impact Investment SBIC, and the Early Stage SBIC—each of which generally operate by a similar lending mechanism. The SBA, in a multi-step process, effectively
lends money at relatively low, fixed rates,\textsuperscript{28} to privately managed investment funds, known as SBICs, which are regulated by the SBA after successfully applying for SBIC designation.\textsuperscript{29} An SBIC may then lend or invest its mixture of private and SBA-guaranteed capital to early stage small businesses with hopes of profits above their borrowed rates.\textsuperscript{30} The availability of government-backed debt and equity improves small business access to long-term debt and private equity, in turn financing operations and expansion.\textsuperscript{31}

Since its creation by the Small Business Investment Act of 1958,\textsuperscript{32} the Debenture SBIC program has grown into the SBA’s primary lending scheme for small business investment, distributing almost $60 billion in long-term debt and equity capital to more than 107,000 small businesses by 2011.\textsuperscript{33} In its early years the program largely consisted of inexperienced capital investors specializing in real estate activities with the minimum requirement of private capital (originally $150,000).\textsuperscript{34} By the 1970s the program had roughly 300-500 Debenture SBICs operating with notable investment expertise playing the “leading role” in the venture capital industry.\textsuperscript{35} Among its successes, the Debenture SBIC program was seen as critical to the initial investment of Silicon Valley,
because it “helped spawn the institutional framework—law firms, accountants and research firms—that the industry originally needed.” Notable recipients of Debenture SBIC financing include Apple, FedEx, Costco, Intel, and Staples.

Today the Debenture SBIC remains the most commonly utilized lending scheme. As of March 2012, the SBA oversaw the operation of 141 Debenture SBICs out of 293 total SBICs. Further, the mixture of private and SBA at-risk capital for Debenture SBICs totaled just under $12 billion; all other licensee categories combined to roughly $5.5 billion. Together there are roughly 300 SBICs operating with about $17 billion in management. The program closed a record fiscal year in 2011, during which 1,339 small businesses received a mixture of $1.1 billion in private capital and $1.82 billion in SBA capital, effectively creating or sustaining an estimated 56,211 jobs.

The Impact Investment SBIC program is a development tool whose participating funds are required to invest a minimum of 50% of capital in “areas of critical national priority including underserved markets and communities facing barriers to access to credit and capital.” Both the Debenture and Impact Investment SBICs are more suitable for investors “targeting later-stage companies with cash-flow.”

36. Vardi, supra note 11.
38. The number and capitalization of Debenture SBICs declined in the 1980s for a variety of reasons, including extremely high interest rates, limited leverage, the growth of large venture capital firms, and the use of pension funds and endowments as large providers of venture capital. By the early 1990s, out of the mere 180 SBICs in operation, 80 bank-owned funds did not take down leverage. With significant policy revisions in the early 1990s, SBICs have again grown in importance as a capital resource. Staebler I, supra note 2, at 3.
40. Id.
42. SBIC STATISTICS, supra note 15, at 2.
44. SBIC Program Overview, supra note 27.
In contrast, the Early Stage SBIC program is directed toward equity investment in early stage small businesses. Because the new program has been largely modeled on the Debenture SBIC program in efforts to replicate aspects of its proven success and to avoid the regulatory complexity of implementing a new lending platform, further examination of the Early Stage SBIC program requires an initial understanding of Debenture SBIC lending.

B. Debenture SBIC Lending

Congress does not directly allocate funds to the SBA for Debenture SBIC lending. Instead, the SBA raises funds as needed by the sale of debt securities known as debentures, which entitle their holders to receive scheduled “interest and principal payments [from the SBA] over a certain period of time.” The SBA lends the funds from debenture sales at an interest rate following the yield on the U.S. 10-year Treasury Note, which was near historic lows at 2.25% in September 2012. Those funds are lent to Debenture SBICs as leverage in the form of debt to be repaid typically within ten years.

Debt leverage to Debenture SBICs, however, may only supplement the investment fund’s pre-existing private capital. Typically, Debenture SBICs will receive SBA debt leverage that is twice the amount of pre-existing private capital, but a Debenture SBIC that has successfully managed more than one investment fund may be eligible for the statutory maximum of up to three-times its private capital. In either case, the SBA generally caps total lending to a single Debenture SBIC investment fund at $150 million.

45. Id.
46. Financing Options Explained, SMALL BUS. ADMIN., (2012) available at http://www.sba.gov/content/financing-options-explained (last visited December 20, 2012) (explaining that to finance investments specifically for standard Debenture SBICs, the SBA sells “standard debentures” which are non-amortizing debt securities with semi-annual interest payments fixed within six months of issuance at a premium over the 10-year U.S. Treasury Note).
47. SBIC 2012 ANNUAL REPORT, supra note 13, at 12.
48. CONG. RESEARCH SERV., supra note 20, at 8 (noting that a licensee can prepay either in whole, or at the end of the 10-year term).
49. 13 C.F.R. § 107.230 (2012). Unless the SBA allows an investment fund to draw leverage while in the process of securing private capital.
50. CONG. RESEARCH SERV., supra note 20, at 19.
51. Id. (noting that a group of Debenture SBICs under common management may
The borrowing costs of debt leverage to Debenture SBICs include not just interest payments, but also additional management fees. Since the SBA runs the program "on a zero-subsidy basis" it recovers its expenses mostly by these fees. Debenture SBICs must pay the SBA a 3% origination fee for each debenture issued (1% at commitment and 2% at draw), an annual fixed leverage fee, and other administrative and underwriting fees that are adjusted annually. The Debenture SBIC investment fund can prepay the ten-year term without penalty, but the prepayments must be fully paid on scheduled (semi-annual) payment dates. In turn, SBIC fund managers may take the debt leverage borrowed at these rates and invest or lend to small businesses for profit.

However, Debenture SBICs may invest in or lend to only certain small businesses that meet both statutory requirements and also the requirements of the SBA's Office of Size Standards. To qualify as "small," they must have relatively little net worth and annual income—generally, net worth of less than $18 million and with average after-tax income of less than $6 million for the prior two years. Debenture SBICs are also prohibited from investing in real estate, project finance, companies with more than 49% of their employees outside of the U.S., or investments in "passive" entities or activities, meaning that the business does not perform business operations. Additionally, Debenture SBICs are required to dedicate 25% of financing toward "smaller businesses"—those which have a tangible net worth of less than $6 million and have average after-tax income of less than two million for the prior two years.

Investment managers find the commonly-utilized Debenture SBIC leverage attractive because qualifying investment funds can rapidly deploy SBA-provided debt at relatively low rates and under flexible terms, effectively multiplying the amount of private capital

receive debenture leverage of up to $225 million).

52. Id. at 9.
53. Id.
54. Id. at 8.
raised for a project by a ratio of up to 3:1\textsuperscript{58} and ultimately increasing financial scale for improved returns to investors.\textsuperscript{59} Additionally, organizational advantages include a flexible fund structure and SEC registration exemption benefits.\textsuperscript{60} Small businesses, the ultimate recipients, find the Debenture SBIC lenders attractive because other sources of private equity may be prohibitively expensive or otherwise unavailable because of company size, oversight costs, return potential, or geographic location.

The Debenture SBIC program, originally designed to encourage equity investment in small businesses,\textsuperscript{61} over time evolved to favor mature, "later-stage companies with cash flow." Because Debenture SBICs repay the SBA for current-paying, interest bearing debts, investment funds found it unattractive and risky to make equity investments in early stage small businesses, which are typically unprofitable, making it difficult for Debenture SBICs to make initial interest payments.\textsuperscript{62} The effect of this: many small businesses in need of investment early in their life-cycles have been effectively unable to access Debenture SBIC equity.\textsuperscript{63}

C. Participating Securities SBICs (Discontinued in 2004)

The SBA first attempted to address the Debenture SBIC lending gap for early stage small businesses in 1994, establishing the Participating Securities SBIC Program\textsuperscript{64} as a way to encourage equity

\textsuperscript{58} CONG. RESEARCH SERV., supra note 20, at 19 (noting that recent legislation raised the Debenture SBICs maximum leverage ratio from 2:1 to 3:1. So, for example, if a Debenture SBIC possesses 10 million in private capital, then it may borrow typically $20 (max $30) million in SBA debt. The SBA raises money to lend through the sale of standard debentures.


\textsuperscript{60} Id (noting that “SBICs are exempt from SEC registration requirements. Yet, LPs benefit from the careful monitoring done by the SBA, greatly reducing the risk for fraud and abuse.”).


\textsuperscript{62} Id.

\textsuperscript{63} Garland, supra note 7.

\textsuperscript{64} See generally Small Business Credit and Business Opportunity Enhancement Act
investments in small business start-ups. Congress appropriated $2 billion for the program spread over the course of five years. It was anticipated that with such a significant funding commitment, SBIC lenders would "once again become serious players in buyouts and early stage finance."

To raise this money, the SBA sold undivided interests in a pool of participating securities debentures to investors on the open market, guaranteeing a preferred rate of return. These debentures were valuable compared to other securities offered on the market because of the SBA's guarantee, inclining investors to accept a lower payment rate.

The SBA intended to repay the debentures by participating in the profits of investment funds that had financed successful small business start-ups. So unlike Debenture SBICs, to which the SBA offers leverage in the form of debt, Participating Securities SBICs were provided leverage best described as "equity-flavored." In return for leverage invested, the SBA received preferred stock, income bonds, or a preferred limited partnership interest in the Participating Securities SBIC that in turn made the equity investments in small businesses.

In a complex arrangement, a Participating Securities SBIC repaid interest to the SBA by issuing dividends on preferred stock, offering interest on income bonds, or delivering a priority return on a preferred limited partnership interest at a yearly, designated rate. In effect, the SBA was repaid for these equity-flavored instruments only
out of profits.\textsuperscript{74} These were known as "Priority Payment[s.]")\textsuperscript{75} A Participating Securities SBIC was also obligated further to repay the original "face amount"\textsuperscript{76} of the leverage through "Redemption Payments" either before or at the end of a ten-year term.\textsuperscript{77}

As a way to address the profit difficulties for start-ups,\textsuperscript{78} the SBA offered to cover the Participating Securities SBIC's "required quarterly payments to investors, at least during the early years of the investment."\textsuperscript{79} The burden-shift arose out of the SBA's own self-interest, because fund managers, no longer forced to squeeze their young companies for cash to pay quarterly interest, could instead devote more money and energy to prospects for long-term growth and profit.\textsuperscript{80} The SBA anticipated that, over time, it would be reimbursed for shouldering early guaranteed payments through both profit participation and also preferred dividends paid by Participating Securities SBICs that had financed successful early stage small business.\textsuperscript{81}

The profits for successful start-ups should have covered the losses of struggling ones, but the SBA usually limited its profit participation to a mere 8%, which distributed profits to successful investors before SBA received its return of capital.\textsuperscript{82} Although this risk was recognized at the time Participating Securities SBIC licenses were introduced,\textsuperscript{83} ultimately the SBA did not operate a clear and effective

\begin{footnotesize}
\begin{enumerate}
\item Final Rule: Small Business Investment Companies; Leverage; Participating Securities; Conditions Affecting Good Standing of Licensees, 59 Fed. Reg. 16898, 16903 (Apr. 8, 1994) ("Since Prioritized Payments on Participating Securities are payable only to the extent of earnings, SBA realizes that the repayment of its guarantee payments will depend upon the ability of its Licensees to operate profitably as equity investors.").
\item 13 C.F.R. § 107.1250 (2012).
\item Offering Circular, supra note 73.
\item Id.
\item As mentioned earlier, it is generally unattractive for Debenture SBICs to make equity investments in unprofitable, early stage small businesses; no profits made it difficult for Debenture SBICs to make initial interest payments to the SBA.
\item CONG. RESEARCH SERV., supra note 20, at 10.
\item Id.
\item See Proposed Rule: Small Business Investment Companies; Leverage; Participating Securities; Conditions Affecting Good Standing of Licensees, 58 Fed. Reg. 41852, 41855 (Aug. 5, 1993) ("[T]he SBA anticipates that it will be repaid most of such guaranty payments through a combination of Earned Prioritized Payments and Profit Participation.").
\item Garland, supra note 7.
\item Bartlett, supra note 61, at 607 ("Perhaps the most controversial aspect of the program is the threat that leverage will be lost when and as investments are harvested by a licensee because the distribution policy set out in the statute and regulations is out of step with the profit-sharing arrangements.").
\end{enumerate}
\end{footnotesize}
A repayment scheme that adequately considered the volatility of the asset class.84 Over the course of the program, the SBA ended up contributing 62% of the capital utilized by these investment funds, but was repaid with only 34% of the profits of the successful ones.85 Also many funds invested in Internet start-up companies that subsequently collapsed in the early-2000s, compounding this volatility problem.86 In the end the Participating Securities SBIC program failed because it used an overly-complex regulatory scheme whose repayment model did not correctly evaluate the risk of the SBA’s investments in participating investment funds.87

The SBA stopped issuing licenses for the Participating Securities SBIC program in 2004, yet there remain commitments to repay purchasers of the guaranteed certificates.88 Currently there are 89 licensees still in operation with outstanding commitments of $1.7 billion.89 Additionally the SBA has leverage of $1.4 billion in 81 funds currently in liquidation.90 The number of Participating Securities SBICs that remain is steadily waning:91 over the previous nine quarters, the Administration transferred 12 funds owing $457 million to its Liquidation Department and also “pursued lawsuits against another 13 . . . for $500 million.”92 Some Participating Securities SBICs gained notoriety as they lost private and taxpayer money alike, including L Capital, an investment fund that borrowed over $96 million in SBA leverage, a cost falling on the taxpayer.93 Other disappointments included ECentury

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84. Garland, supra note 7 (quoting Suzette Dutch, managing partner at Triathlon Medical Ventures, a life-sciences venture firm).
85. SBIC 2012 ANNUAL REPORT, supra note 13, at 30 (noting that the “majority of the capital was allocated between 1999 and 2004, some of the worst years in venture capital.”).
86. SBIC 2012 ANNUAL REPORT, supra note 13, at 30.
87. Garland, supra note 7 (quoting Suzette Dutch, managing partner at Triathlon Medical Ventures, a life-sciences venture firm).
88. See Offering Circular, supra note 73. (noting that since October 1, 2004, SBA has not issued new commitments for Participating Securities SBICs because the fees paid to the SBA have not covered its net losses; the final Offering Circular Participating Securities certificates took place on February 19, 2009).
89. SBIC STATISTICS, supra note 15, at 1.
90. Id.
91. Id.
92. Vardi, supra note 11.
93. Id.
Capital Partners, Cardinal Growth, and Avalon Equity.  Although the program did provide access to equity for early stage small businesses, the program was unsustainable in the face of its losses, and, as a result, government-backed equity investments lost favor in the Administration.

III. EARLY STAGE SBIC LENDING

Since the SBA stopped issuing Participating Securities SBICs licenses in 2004, the gap in lending for early stage small businesses has persisted. The SBA has estimated that the annual unmet need for small business equity has measured up to $60 billion over the last five years. In that time, less than 10% of all venture capital in the United States was small business equity, almost 70% of which was invested in just three states: California, Massachusetts and New York. Some start-ups in need of equity have found themselves trapped in the so-called "Valley of Death," the $1-4 investment range, where it is especially difficult to procure seed money.

The new Early Stage SBIC program intends to address this lending gap, building on the experiences both of its discontinued predecessor, the Participating Securities SBIC program, and of the successful Debenture SBIC program, on which it has been generally modeled. Since the goal of the Early Stage SBIC program is to encourage that SBA leverage be invested as equity in young, unprofitable small businesses, it significantly departs from its model Debenture SBIC program in a variety of additional regulations. Initial

94. Id.
95. SBIC 2012 ANNUAL REPORT, supra note 13, at 31 (noting that, according to SBA estimates, the Participating Securities SBIC program has funded 14.8 billion in financing, financed 4,062 small businesses, and created or sustained 387,929 jobs (citing Measuring the Importance of Venture Capital and Its Benefits to the United States Economy, DRI-WEFA, June 19, 2002; Cook & Nevins, The 1999 Arizona Venture Capital Impact Study, THE ZERMATT GROUP, March, 1999.)
96. Staebler I, supra note 2, at 3.
97. CONG. RESEARCH SERV., supra note 20, at 21 (citing H.R.REP. No. 111-31 (to accompany H.R. REP. No. 3854, THE SMALL BUSINESS FINANCING AND INVESTMENT ACT OF 2009, 3)).
98. SBA EARLY STAGE INITIATIVE, supra note 9, at 1.
99. Id.
100. Id.
applicants and licensed Early Stage SBICs must comply with additional rules and requirements when first applying, acquiring private capital, drawing leverage, repaying debts, and defaulting on loans.

A. Applying for an Early Stage SBIC License

As participants, the SBA hopes to attract lenders and investment fund managers with histories of investing in companies at early growth stages to participate in the new Early Stage program.\textsuperscript{102} The SBA will consider the qualifications of the fund’s management, the performance of the management’s prior investments, the proposed investment strategy, and the applicant’s proposed organizational structure and financial projections.\textsuperscript{103} These considerations for evaluating Early Stage SBIC applicants largely match those for Debenture SBICs, although they are more heavily scrutinized.\textsuperscript{104} “The SBA does not plan on relaxing its licensing standards in connection with the [Early Stage SBIC] program; indeed, it has emphasized that [] applicants will need to demonstrate superior qualifications in these key areas.”\textsuperscript{105}

As an additional consideration, the SBA also intends to diversify lending to Early Stage SBICs according to vintage year\textsuperscript{106} and geographic location of applicants.\textsuperscript{107} The SBA “wants to avoid an excessive concentration” of Early Stage SBICs licensed in one particular year as a way to reduce risk to the overall program.\textsuperscript{108} The SBA also will be less likely to license multiple Early Stage SBIC applicants located in a particular geographic area.\textsuperscript{109} However, since applicants are currently in the first round of licensing, it is not yet entirely clear how the additional considerations for vintage year and geographic concentration will affect applicants.\textsuperscript{110}

The SBA has standardized several aspects of the application process in an effort to streamline it for both the applicant and the

\textsuperscript{102} Early Stage Call 2012, supra note 1, at 25779.
\textsuperscript{103} See 13 C.F.R. § 107.305.
\textsuperscript{104} Haynes & West, supra note 18, at 2.
\textsuperscript{105} Id. at 3.
\textsuperscript{106} 13 C.F.R. §107.320(a)
\textsuperscript{107} 13 C.F.R. §107.320(b)
\textsuperscript{108} Haynes & West, supra note 18, at 2.
\textsuperscript{109} Id.
\textsuperscript{110} Id. at 2-3.
Instead of a rolling application period, Early Stage SBIC applicants may apply only according to annual calls in the Federal Register, giving the SBA a chance to perform a group evaluation, a "beauty pageant [to] select the strongest candidates."112

It appears that Early Stage SBIC applicants have little flexibility to depart from the Model Limited Partnership Agreement (LPA). The Model LPA requires that an Early Stage SBIC must be organized as a limited partnership according to an SBA-provided template.113 This requirement is absolute and may not be waived unless the fund successfully applies as a drop-down structure. Some applying investment funds may already have limited partnership agreements in place and not want to revise them. The SBA recommends that applying investment funds change as little as possible in order to maximize the efficiency of the standardized application during the licensing process.114 Overall, the SBA has noted that deviations from the Model LPA will not only require a narrative explanation but also a "substantive basis," which the SBA may ultimately not find convincing.115

Investment funds applying for Early Stage SBIC licenses must possess private capital116 of at least $20 million to be considered eligible.117 This is a higher minimum threshold than for Debenture SBICs at $5 million, but since the SBA rarely gives less than $15 million to any SBICs of any sort, this aspect of the program fits common SBA behavior.118 Additionally, the SBA will charge a $25,000 non-refundable licensing fee, which is $10,000 more expensive than for a Debenture SBIC.119

111. LIMITED PARTNERSHIP AGREEMENT, supra note 4, at 2.
112. Haynes & West, supra note 18, at 3.
113. LIMITED PARTNERSHIP AGREEMENT, supra note 4, at 4-5 (noting allowed circumstances for drop-down provisions, located in "ANNEX FOR DROP DOWN PROVISIONS").
114. Early Stage Call 2012, supra note 4, at 25778 ("SBA encourages applicants to adhere to the Model LPA to the maximum extent possible.").
115. Id.
116. See Bartlett, supra note 61, at 589 ("[F]or all practical purposes and assuming the capital is contributed in cash, private capital and regulatory capital are the same.").
118. Haynes & West, supra note 18, at 2.
119. Id.
B. Restrictions on Sources of Private Capital for an Early Stage SBIC

Concerning permitted sources of private capital, the SBA places identical restrictions on Early Stage SBICs as on Debenture SBICs. Private capital may come from two sources: (1) a licensee's capital that he or she pays into to the fund and, (2) unfunded, binding commitments from institutional investors to contribute to the fund. Cash is ideal because it is not subject to the limitations restricting sources of non-cash contributions, which include U.S. government debts, accounts receivable, tangible assets used in business operations and a few others.

An Early Stage SBIC must meet a diversity requirement stipulating that at least thirty-percent of its private capital originates from three different individuals affiliated neither with the fund’s management nor with one another. No single individual entity may provide more than 70% of a fund’s capital unless approved by the SBA.

C. Early Stage SBIC Lending: Borrowing SBA Leverage and Investing Equity in Small Businesses

The Early Stage SBIC program has been approved to distribute $1 billion in leverage to Early Stage SBICs in increasing allocations through 2016: $150 million in 2012; $200 million in the years 2013-2015; and, $250 million in 2016. Investment funds will receive leverage in smaller sums than for Debenture SBICs and Participating Securities SBICs. Instead of a ratio of 3:1 or 2:1, SBA leverage to Early Stage SBICs may, at most, only match pre-existing private capital. So, for example, an Early Stage SBIC with $50 million in

\[ \text{Equity} \]

Cash is ideal because it is not subject to the limitations restricting sources of non-cash contributions, which include U.S. government debts, accounts receivable, tangible assets used in business operations and a few others. An Early Stage SBIC must meet a diversity requirement stipulating that at least thirty-percent of its private capital originates from three different individuals affiliated neither with the fund’s management nor with one another. No single individual entity may provide more than 70% of a fund’s capital unless approved by the SBA.

C. Early Stage SBIC Lending: Borrowing SBA Leverage and Investing Equity in Small Businesses

The Early Stage SBIC program has been approved to distribute $1 billion in leverage to Early Stage SBICs in increasing allocations through 2016: $150 million in 2012; $200 million in the years 2013-2015; and, $250 million in 2016. Investment funds will receive leverage in smaller sums than for Debenture SBICs and Participating Securities SBICs. Instead of a ratio of 3:1 or 2:1, SBA leverage to Early Stage SBICs may, at most, only match pre-existing private capital. So, for example, an Early Stage SBIC with $50 million in

\[ \text{Equity} \]
private capital may receive up to the $50 million maximum of SBA leverage.

An Early Stage SBIC receiving SBA leverage must invest in businesses that are not only “small” but also considered “early stage.” To be considered “small,” restrictions entail that individual businesses must either (1) have a tangible net worth of less than $18 million and have an average after-tax income for the previous two years of less than $6 million or (2) typically employ fewer than 500 employees.\footnote{127} An Early Stage SBIC must invest at least 50% of its investment capital into small businesses that qualify as “early stage,” meaning that they have never operated a positive cash flow in any fiscal year by the time of the Early Stage SBIC licensee’s initial financing.\footnote{128} The SBA will determine whether the portfolio meets the 50% test when the fund’s investments at least reach the size of the Early Stage SBIC’s private capital.\footnote{129} The measurement of investment activity will be “tricky” because of the timing issues involved in SBIC investments and because if the fund fails to meet this new regulatory requirement, it may constitute an event of default.\footnote{130}

Lastly, Early Stage SBICs must seek the SBA’s approval to hold, incur, or refinance any third party debt; because SBA leverage is treated as equivalent to third party debt during bankruptcy proceedings, the SBA insists that it control the amount of third party debt an Early Stage SBIC may take on as a way to protect its priority in repayments.\footnote{131}

\textbf{D. Repaying SBA Leverage as an Early Stage SBIC}

Overall, the SBA has created a repayment scheme that attempts to protect both the SBA and also Early Stage SBICs by limiting the risk of losses typically associated with small business start-ups. The SBA will raise its money through the sale of debentures in sales similar to those operated for Debenture SBICs. The type of debenture on which the Early Stage SBIC draws leverage will determine its repayment

\begin{itemize}
  \item \footnote{127}{13 C.F.R. § 121.201 (2012).}
  \item \footnote{128}{Early Stage Call 2012, \textit{supra} note, at 25775.}
  \item \footnote{129}{Haynes & West, \textit{supra} note 18, at 5.}
  \item \footnote{130}{\textit{Id.}}
  \item \footnote{131}{\textit{Id. at 1}.}
\end{itemize}
schedule options.

The SBA has stipulated that Early Stage SBICs may only draw leverage in the form of debt and not equity, 132 for a change from the Participating Securities SBIC program. 133 A steady debt interest schedule offers a more stable repayment structure for the SBA than a comparatively volatile equity interest in profit participation.

Early Stage SBICs may draw discount debenture leverage, which is issued with a discount that “cover[s] the interest and annual charges for the first 5 years.” 134 In effect, an Early Stage SBIC is permitted to defer interest payments on its debt for the first five years, during which its small businesses investments are most likely to be unprofitable, making it more attractive for it to invest equity and oversee risky small businesses.

Alternatively, an Early Stage SBIC may also take standard debenture leverage (which is available to Debenture SBICs), but it is required to maintain a reserve from which it can repay five years of interest and principal payments. 135 The investment fund elects at the issuance of the obligation its preferred form of repayment. 136

Early Stage SBICs repay debt leverage at a fixed, contracted interest rate along with additional management fees. Like the Debenture SBIC program, the SBA runs the Early Stage SBIC program “on a zero-subsidy basis” recovering its expenses largely through these management fees. 137 As mentioned earlier, the SBA will first charge a $25,000 non-refundable licensing fee. 138 Among other fees charged,
Early Stage SBICs "must pay a 2% draw fee at the time of the draw."\textsuperscript{139} Also required are annual fixed leverage fees combined with other administrative and underwriting fees that are adjusted annually.\textsuperscript{140} The SBA will charge Early Stage SBICs an audit fee ten percent higher than that for Debenture SBICs, because the SBA plans to rigorously audit these new investment funds, keeping close watch on unrealized investments in Early Stage SBIC portfolios.\textsuperscript{141}

E. Defaulting on Leverage as an Early Stage SBIC

The ratio of leverage to private capital, known as a Capital Impairment Percentage (CIP), is the key calculation used by the SBA to determine an SBIC's fiscal health.\textsuperscript{142} Essentially, if an Early Stage SBIC using discount debentures borrows less than half of the leverage available to it, the SBA will not have first priority (over private lenders and investors) in receiving repayments until an Early Stage SBIC experiences such significant losses—typically 70 percent—that it surpasses its capital impairment percentage.\textsuperscript{143} With this change, Early Stage SBICs should be encouraged "to manage their risk by taking down less leverage."\textsuperscript{144} Additional changes to the CIP calculation are listed in C.F.R. §107.1845.\textsuperscript{145}

IV. SUMMARY OF ADVANTAGES OF EARLY STAGE SBICs

As investment funds, banks, and other lenders encounter Early Stage SBICs over the next several years, they may find it attractive to participate themselves. The principal reason for an investment firm to seek an SBIC license is for access to SBA leverage.\textsuperscript{146} Investors should find Early Stage SBIC leverage particularly appealing because participating funds will have the capacity to rapidly deploy SBA leverage, not only offered at the relatively low interest rates bound to

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\textsuperscript{139} See Bartlett, supra note 61, at 589.
\textsuperscript{140} CONG. RESEARCH SERV., supra note 20, at 9.
\textsuperscript{141} Haynes & West, supra note 18, at 2.
\textsuperscript{142} 13 C.F.R. § 107.1840 (2012).
\textsuperscript{143} SBA EARLY STAGE INITIATIVE, supra note 9, at 9.
\textsuperscript{144} Id.
\textsuperscript{145} 13 C.F.R. § 107.1845 (2012).
\textsuperscript{146} Staebler I, at 1.
\end{flushleft}
the 10-year Treasury Note\textsuperscript{147} but also whose repayments are deferred for five years under discount debentures, ultimately increasing financial scale and improving returns.\textsuperscript{148} Early stage small businesses, the ultimate recipients of Early Stage SBIC leverage, should find the equity attractive because similar private capital may be prohibitively expensive or otherwise unavailable because of company size or geographic location.\textsuperscript{149}

Because of the program’s efforts to encourage equity investment in small business start-ups, some complex and burdensome qualities of Participating Securities SBICs and Debenture SBICs have been altered or eliminated for Early Stage SBICs. The imbalanced distribution scheme utilized by the Participating Securities program has been replaced with a simple “pro rata” repayment standard.\textsuperscript{150} Underlying is the SBA’s priority in recovery in the event of default.\textsuperscript{151}

Additionally, the standard LPA should both simplify and expedite the application process for both the investment fund and the SBA.\textsuperscript{152} Applicant investment funds will generally not have the choice to register as anything but an LP, simplifying a “complicated and highly fact-driven” choice for Participating Securities SBICs.\textsuperscript{153} It will likely make the licensing process somewhat less expensive for applicants, since they will require fewer hours drafting individualized contracts.\textsuperscript{154} Also eliminated will be the Participating Securities SBIC’s complicated, profit-based repayment model constructed on preferred stock dividends, income bonds and preferred limited partnership interests; instead, investment funds will repay interest quarterly on either standard or discounted debentures in a process similar to the Debenture SBIC program model.\textsuperscript{155}

SBA leverage in the form of debt creates a steadier and more stable repayment schedule than a comparatively volatile equity interest,
such as profit participation. The ability of Early Stage SBICs to access discount debenture leverage\textsuperscript{156} is particularly advantageous because Early Stage SBICs can defer interest payments on the debt for five years.\textsuperscript{157} This should allow Early Stage SBICs to focus on improving the operations of small businesses in which they invest rather than on struggling to repay the SBA during the years in which early stage small businesses are typically unprofitable.\textsuperscript{158}

Other organizational advantages may make Early Stage SBICs especially attractive vehicles for investment funds, banks, and other lenders. SBIC status, including Early Stage SBIC status, confers a number of regulatory benefits on its participants.\textsuperscript{159} Investment funds are exempted from SEC registration requirements, but are still monitored by the SBA, which reduces the risk for fraud and abuse.\textsuperscript{160}

Banks may find Early Stage SBICs, or other SBICs in general, of significant interest as they seek new strategies for making equity investments exempt from the restrictions of the Volcker Rule. The Volcker Rule, whose primary thrust prohibits banking entities from engaging in proprietary trading activities,\textsuperscript{161} may take its final shape sometime in 2013.\textsuperscript{162} Despite uncertainty about when and how it will take effect, it is imperative that banks, lenders, fund managers, investors, and attorneys take proactive steps to ensure compliance.\textsuperscript{163} Some investment banks, including Goldman Sachs, Morgan Stanley, and Bank of America have already "spun-out" their private equity programs in anticipation, but such funds are less attractive to investors than bank-sponsored funds.\textsuperscript{164} Investment banks, with their reserves of

\textsuperscript{156} As previously mentioned, Debenture SBICs and Impact Investment Licensees cannot access discount debenture leverage.

\textsuperscript{157} LIMITED PARTNERSHIP AGREEMENT, supra note 4, at

\textsuperscript{158} Haynes & West, supra note 18, at 9.

\textsuperscript{159} Public Webinar, supra note 59, at 4-5.

\textsuperscript{160} Id.

\textsuperscript{161} Small Business Investment Companies: An Investment Option for Banks, A Web and Telephone Seminar, OFFICE OF THE COMPTROLLER OF THE CURRENCY, 1 (Feb. 15, 2012) (noting that such activities include the acquisition or sponsorship of a hedge fund or private equity fund).

\textsuperscript{162} Victoria Finkle, "From the House, a Request to Delay the Volcker Rule," AM. BANKER (Jan. 1, 2013).


\textsuperscript{164} Id.
capital, provide a sense of security to potential limited partners, encouraging them to invest; they also provide a valuable network of employees experienced in handling and capitalizing equity investments.\textsuperscript{165}

Banks are permitted to invest up to 5\% of their "total Tier 1 capital in SBICs, allowing it to exceed the 3\% cap stipulated by the Volcker Rule.\textsuperscript{166} In this way, banks can indirectly invest larger amounts of capital than is otherwise proscribed by the Volcker Rule. However, banks must be wary to avoid certain types dealings that might be seen as impermissible "strategic relationships" with SBICs. Generally, a bank is a sponsor or investor in an SBIC if it is a general partner. A bank in the position of advising, managing or sponsoring an SBIC, including an Early Stage SBIC, may not lend or extend credit to the investment fund,\textsuperscript{167} nor may it purchase or invest in securities issued by the SBIC. A bank may generally not purchase an SBIC’s assets\textsuperscript{168} or accept securities or debts as collateral or for credit.\textsuperscript{170} A bank may not issue guarantees, acceptances, or letters of credit on behalf of an SBIC,\textsuperscript{171} and no bank may participate in certain types of prohibited securities lending, borrowing or derivative transactions.\textsuperscript{172} These qualify as "covered transactions"\textsuperscript{173} that are prohibited.

When a bank invests in an SBIC, it may additionally receive special treatment under the Community Reinvestment Act (CRA), which is intended to encourage "banks and federal savings associations to meet the credit, investment, and service needs of the local communities in which they are chartered," and practice safe banking practices.\textsuperscript{174} The valuable aspect of the CRA for banks is that a bank can receive CRA consideration by investing in an SBIC that is located outside of the bank’s local community if that SBIC simply operates in

\textsuperscript{165} Id.
\textsuperscript{166} Id.
\textsuperscript{167} 12 U.S.C. 371(c); The Federal Reserve Act § 23A.
\textsuperscript{168} Id.
\textsuperscript{169} Id.
\textsuperscript{170} Id.
\textsuperscript{171} Id.
\textsuperscript{172} 12 U.S.C. 371(c); The Federal Reserve Act § 23A.
\textsuperscript{173} Id.
Also, it may presumptively qualify for the credit.  

V. CONCLUSION

The architects of the Early Stage SBIC program faced the challenge of transforming an overly-complex and risk-insensitive equity investment scheme into an effective and sustainable source of capital for early stage small businesses. Instead of creating an entirely new lending platform, the SBA instead modeled its new program on the Debenture SBIC’s pre-existing structure. With changes in place that significantly limit the SBA’s at-risk leverage, including a lower maximum leverage ratio, a lower ceiling in maximum borrowing, a more streamlined application process, a simplified and consistent LPA requirement, and a smaller overall funding allocation, the Early Stage SBIC initiative should stand a better chance of operating as a sustainable source of capital for early stage small businesses than its predecessor Participating Securities SBIC program. Fund managers should find this to be an inexpensive, if highly regulated, source of investment capital that can be dedicated to promising early stage small businesses. Small businesses, on the receiving end, will have access to a useful source of otherwise unavailable growth capital.

The recent sharp increases in “first-time applicant” approvals perhaps suggests that banks may generally find SBICs as viable alternatives to traditional investment funds. Early Stage SBICs represent a way to expand the traditional range of SBIC investment to include small business start-ups. Investors, banks, and other lenders interested in early stage small business investment may find that Early Stage SBICs offer valuable advantages to their participants.

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175. Id.
176. SBA EARLY STAGE INITIATIVE, supra note 9, at 11.
177. See Frydman, supra note 163 (noting that more study on this issue is needed).