



## Small Business Investment Company Investment Diversification and Growth Final Rule Summary

SBA is revising regulations for the Small Business Investment Company ("SBIC") program to significantly reduce barriers to program participation for new SBIC fund managers and funds investing in underserved communities and geographies, capital intensive investments, and technologies critical to national security (87 FR 63436). The rule introduces an additional type of debenture instrument ("Accrual Debentures") to increase program investment diversification and long-duration financing for Small Businesses, modernizes program rules to lower financial barriers to program participation, and incorporates the statutory requirements of the *Spurring Business in Communities Act of 2017*, which was enacted on December 19, 2018. This final rule implements proposed regulatory changes as modified to address comments SBA received during the rulemaking process.

### Executive Summary

- 1) Introduces a new type of Debenture ("Accrual Debenture") designed to align with the cash flows of longer duration and equity-oriented funds ("Accrual SBICs" and "Reinvestor SBICs").
- 2) Revises the existing prohibited investment requirements under 13 CFR § 107.720 that permit SBICs to invest in relenders or reinvestors under specific circumstances enabling the introduction of the "Reinvestor SBIC".
- 3) Modernizes the licensing, operations, and examinations rules to lower costs and administrative barriers faced by new funds applying to the SBIC program.
- 4) Implements a formal licensee "Watchlist" process to strengthen program risk management.
- 5) Implements a consistent approach to investor and SBA distributions for issuers of Accrual Debentures to mitigate default and loss risk while maximizing incentives to investors in Accrual and Reinvestor SBIC funds.
- 6) Implements several modernization improvements in response to industry feedback over several years to improve the experience of program participants and reduce time and cost burdens.
- 7) Formally implementing the *Spurring Business in Communities Act*, Pub. L. 115-333.

### Detail

1. **Publication of SBIC License announcements.** SBA will publish license approvals in the Federal Register within 30 business days of the end of the month in which the license was approved by the SBA Administrator.
2. **Expedited subsequent funds licensing process.** Introduce an expedited subsequent fund licensing process for eligible applicants while maintaining current risk management standards and practices (see discussion of Expedited Subsequent Fund licensing in section II.D. and revisions to 13 C.F.R. § 107.305).

3. **Introduces a new SBA debenture product for equity-oriented and long-duration funds ("Accrual Debenture").** Introduces the Accrual Debenture, a debenture instrument without a semi-annual interest payment requirement (required for the existing Standard Debenture product) issued at face value that accrues interest over its ten-year term. SBA guarantees all principal and unpaid accrued interest. Interest must be paid in advance of distributions to limited partners. Licensees issuing Accrual Debentures shall not be permitted to make distributions within 12 months of Licensure. In order to determine the maximum amount of leverage that Accrual SBICs and Reinvestor SBICs may have outstanding, SBA will aggregate the total principal leverage plus ten years of accrued interest on such principal to determine the total Accrual Debentures that the Accrual SBIC or Reinvestor SBIC may issue based on the statutory limitation. Accrual SBICs maximum leverage = 1.25x tiers (ratio of SBA debenture leverage to private regulatory capital of 1.25:1.00). Reinvestor SBIC max leverage = 2.0x tiers. The introduction of the Accrual Debenture instrument is intended to ensure that SBA can support the full spectrum private market investments in Small Businesses. Between the existing Standard Debenture and the Accrual Debenture instrument, SBA will increase program flexibility for greater private market participation in the SBIC program resulting in increased financing to small businesses.
4. **Introduces Fund-of-Funds SBIC Licenses ("Reinvestor SBIC" License).** Reduces regulatory restrictions on investments in reinvestors to permit fund-of-funds or "Reinvestor SBICs" with a focus on underserved communities and markets. Reinvestor SBICs can make Equity Capital Investments in underserved non-SBA leveraged limited partnerships, SBICs or non-SBIC licensed funds, that:
  - finance businesses that meet SBA's small business size standards
  - are owned and controlled by U.S. citizens and/or entities headquartered in the United States, and
  - have at least 50 percent of employees based in the United States at the time of investment.

SBA's prior written approval is not required in connection with Reinvestor SBIC co-investments if an unaffiliated and unassociated third-party investor is contributing Equity Capital Investments to the portfolio concern alongside the Reinvestor SBIC. At least one substantial third-party investor, unaffiliated and unassociated with the Reinvestor SBIC, must be investing on the same terms as the Reinvestor SBIC.

5. **Enables SBA to publicly report program-wide, vintage year and strategy specific investment performance.** SBA is modifying the existing Form 468 to consistently collect industry standard investment performance metrics including Total Value to Paid-in Capital, Distributed to Paid-in Capital, Residual Value to Paid-in Capital, and Gross and Net Internal Rate of Return on a quarterly and annual basis. Requires all Leveraged Licensees to submit 468 reports quarterly. SBA will not publish individual Licensee perform. All performance will be reported program-wide and based on vintage year and strategy cohorts.
6. **Defines the term "Total Intended Leverage Commitment" to enable SBA to provide a letter of intent to commitment a specified dollar amount to an SBIC applicant and to support the calculation of the Accrual Debenture distribution waterfall.** SBA is changing regulations to conditionally approve a Total Intended Leverage Commitment

amount at the time of licensing to provide clarity upfront regarding SBA's level of financial support to a prospective Licensee.

7. **Improves the process for approval and examination of Licensee fees/cost of money.** SBA will approve the scope and type of services included or excluded from management fee offsets during the licensing process.
8. **Improves and modifies licensee reporting.** Modifies and modernizes existing SBIC reporting and data collections (Forms 1031 and 468) to Microsoft Excel-based forms that prepopulate data and perform calculations to reduce burden on Licensees. Includes voluntarily reporting of demographic data for licensees and their portfolio concerns. Updates Form 468 to help SBA determine net jobs created and total jobs created or retained, including identifying the number of jobs added due to a business acquisition versus growth in the business. Permits SBICs to aggregate financing data of portfolio concerns on a quarterly basis and submit one Form 1031 inclusive of all financings in the quarter within 30 days of quarter end. Expands the timeframe for quarterly valuation submissions via quarterly 468, including material adverse changes, to 45 calendar days following the close of each quarter. Requires Licensees to submit to SBA any report, beyond Form 1031 and Form 468, it gives to its private investors no later than 30 days after the date on which such SBIC sent any report to its private investors.
9. **Introduces rules in support of program-wide investment diversification.** Introduces program-wide diversification rules which support prioritization of Underlicensed States, underserved markets and undercapitalized industries and technologies, particularly those aligned to seeding, scaling and transitioning technologies critical to U.S. national security.
10. **Clarifies "Dual Commitments" for institutional investors with underlying investors, such as RIAs and Fund-of-Funds, are not necessary if the Licensee's limited partnership agreement (LPA) contains sufficient remedies against defaulting investors.** Revises the definition of *Regulatory Capital* to be more explicit regarding how to interpret the exclusion clause. As such, SBA is revising the exclusion of questionable commitments to clarify that an unfunded commitment may be questionable due to lack of enforceable legal agreements under United States law or an issue of collectability for financial or any other reason, or both. SBA notes that the unfunded commitment of an investor that has satisfied the applicable net worth test set forth in the definition of Institutional Investor will not be of questionable collectability (for financial reasons) if the Licensee's Limited Partnership Agreement (or other governing agreement) contains sufficient remedies against defaulting investor to ensure collection.
11. **Makes clear the distinction between Regulatory Capital and Leverageable Capital.** SBA is revising the definition of Regulatory Capital to highlight the distinction between Regulatory Capital and Leverageable Capital — i.e., that Regulatory Capital which is not in the form of unfunded commitments is Leverageable Capital.
12. **In support of seeding emerging managers, modifies the definition of "Associate" to better distinguish the role of limited partners vs. parties with ownership or control of the general partnership or management company.** SBA modifies the definition of "Associate" regarding the status of an entity Institutional Investor based on its ownership interest in a Licensee. Currently an entity Institutional Investor whose ownership

represents over 33 percent of the Licensee’s Private Capital is considered an “Associate”. SBA is revising regulations to change this to 50 percent or more to align with the financing practices of Community Development Corporations and other institutional investors seeking patient capital investment funds and first-time funds. Under this Final Rule, an entity Institutional Investor, as a limited partner in a partnership Licensee, will not be considered an Associate solely because that entity’s investment in the Partnership, including commitments, represents 10 percent or more but less than 50 percent of the Licensee’s Private Capital, provided that such investment also represents no more than five percent of the entity’s net worth.

13. **Updates “Wind-up” Plan to “Wind-down” Plan.** Changes the term “Wind-up” Plan to “Wind-down” plan throughout part 107 because SBA believes that it better reflects the wind-down of a fund at the end of its life cycle.
14. **Formally defines “Non-Leveraged Licensee” to enable rules and procedures specific to Licensees without SBA Leverage.** Defines Non-leveraged Licensee as a Licensee that has no outstanding Leverage or Leverage commitment thereby enabling more flexibility for this category of Licensee. SBA permits Non-leveraged Licensees (which include both those licensed as Non-leveraged Licensees and Licensees that fully repay Leverage and seek no further Leverage) to adopt a Valuation Policy in accordance with GAAP.
15. **Outlines that an applicant being headquartered in an Underlicensed State can be considered “good cause”.** Changes regulations to specify that one example of “good cause” would be the applicant is headquartered in an Underlicensed State. If licensed, Leveraged Licensees from Underlicensed States with at least \$3 million in Regulatory Capital would be eligible for up to 1 tier of Leverage until they raise the \$5 million minimum Regulatory Capital requirement.
16. **Revised the Licensing Fee Schedule to be backed on fund sequence.** SBA revises the Initial Licensing Fees based on its fund sequence (meaning the order of succession of the fund) as follows:

<b>Fund Sequence</b>	<b>Initial Licensing Fee</b>
Fund I	\$5,000
Fund II	\$10,000
Fund III	\$15,000
Fund IV+	\$20,000

SBA will determine the applicant’s Fund Sequence based on the applicant’s management team composition and experience as a team, including the business plan (also known as the strategy) of the fund provided in Phase I of the application process.

17. **Introduces an applicant resubmission penalty of \$10,000.** Application resubmission penalty fee of \$10,000 for any applicant that has previously withdrawn or otherwise is not approved for a license that must be paid in addition to the Initial and Final Licensing Fees. SBA’s final licensing fees remain below SBA’s expenses required to process such applications. The intent of the resubmission fee is to impose a penalty for each time an applicant resubmits its application to offset the outlay of additional SBA time and resources.

Applicants can request SBA approval to waive the resubmission penalty fee that SBA may consider on a case-by-case basis.

18. **Modernizes Management Qualifications to fit with a broader range of investment strategies and team.** Amends the management qualifications section by adding two management qualifications. The first is relevant industry operational experience, which may be combined with investment skill to demonstrate managerial capacity. The second, if applicable, is the applicant's experience in managing a regulated business, including but not limited to an SBIC.
19. **Formalizes in regulations the SBIC Program Watchlist.** SBA is formalizing in regulations its intent, process and objectives for managing a "Watchlist" of Licensees to prudently manage and mitigate against risk of future defaults, losses and potential for fraud.
20. **Makes clear that SBA will consider the Small Business Investment Act "Statement of Policy" when evaluating the business plan and strategy of an applicant.** Amends the investment strategy section to clarify that the applicant's investment strategy is to be contained in its business plan, as well as to underscore the importance of section 102 "Statement of Policy" of the Act which describes the public purpose of the SBIC program.
21. **Modernizes technology requirements.** SBA eliminates the modem requirement; eliminate the facsimile requirement; and modifies the Equipment and Office Requirements section to more broadly require that SBICs must have technology to securely send and receive emails, scan documents, and prepare and submit electronic information and reports required by SBA.
22. **Provides an approval exemption for Capital Call Lines.** The final rule provides an exemption from SBA pre-approval for Capital Call Lines that SBA would likely have otherwise approved.
23. **Outlines separate distribution requirements based on SBIC Licensee type.** This final rule separates distribution requirements based on three categories of SBICs: (1) Non-Leveraged Licensees; (2) Standard Debenture SBICs; and (3) Accrual SBICs and Reinvestor SBICs. Accrual SBICs are permitted to make tax distributions.
24. **Makes clear both 3(c)(1) and 3(c)(7) funds are permissible.**
25. **Establishes a minimum annual charge floor to 40 bps.** Phases in the floor over time for a smooth transition:
  - a. FY24 – 10 bps
  - b. FY25 – 20 bps
  - c. FY26 – 25 bps
  - d. FY27 – 30 bps
  - e. FY28 – 35 bps
  - f. FY 29 – 40 bps (capped floor)