Hogan Lovells

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SBA announces proposed reforms to SBIC program, including introduction of new Accrual SBIC for growth equity funds

The U.S. Small Business Administration (SBA) proposed wide-ranging revisions to the regulations governing the small business investment company (SBIC) program on Tuesday, October 18, 2022. Among other things, the proposed changes would introduce a new type of Accrual Debenture, issued at face value that would accrue interest over the entire ten-year term of the SBIC (and in some cases longer) and designed to attract venture and growth equity investors into the program. Additional revisions are designed to change the terms for repayment of SBA Leverage, update the SBIC fee structures, facilitate investment by first-time SBIC sponsors and those in underserved communities, revise certain SBIC reporting and valuation standards, as well as to codify or clarify long-standing informal SBA practices and interpretations. The proposed regulations would make nearly three dozen revisions to 13 CFR §107 and §121, and taken together, represent the greatest change to the SBIC program in over a decade.

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SBA's rationale for many of the proposed regulations, promulgated under the U.S. Small Business Investment Act of 1958 (the SBIC Act), is to significantly reduce barriers to participation in the SBIC program for new SBIC fund managers and funds investing in:

i. underserved communities and geographies;

ii. capital intensive investments; and

iii. technologies critical to national security and economic development.

In particular, SBA will give priority in licensing to SBIC applicants located in underserved states, in compliance with the U.S. Spurring Business in Communities Act of 2018.

The full text of the proposed rules is available here. The comment period is set to remain open through December 19, 2022.

I. Accrual Debentures and Accrual SBICs for venture and growth equity

Among the most significant changes is the addition of a new type of debenture, the "Accrual Debenture," which would be available to "Accrual SBICs" and designed to align with the cash flows of long-term, equity-oriented funds.[1] The Accrual Debenture would be issued at face value and accrue interest over its ten-year term where SBA guarantees all principal and unpaid accrued interest.[2] A Licensee[3] would be able to apply for a rollover Accrual Debenture to extend the term for another five years.

The Standard Debenture program currently provides for ten-year maturity, with interest due and payable on a semi-annual basis. This works well for certain investment funds, such as credit funds, that expect to have reliably consistent cash flow over the term of the fund (such as interest payments or loan repayment). Accordingly, as SBA notes in its proposing release, the vast majority of SBIC financings are currently debt-focused investments and not equity-focused investments, for which returns are less predictable and often occur only upon disposition of the equity investment.

By introducing the Accrual Debenture instrument, SBA hopes to encourage more SBIC investments into venture capital and growth equity. The proposed rule defines an Accrual SBIC as one that (a) invests at least 75% of its total financings (based on dollar amount) in Equity Capital Investments, (b) will generally own no more than 50% of the small business concern at initial financing and (c) elects at the time of licensing to issue Accrual Debentures.[4] "Equity Capital Investments" is broadly defined as equity and equity-like investments, specifically including common or preferred stocks, limited partnership interests, certain unsecured subordinated debt (with equity features), options and warrants. Notably, these restrictions would exclude participation by funds with control equity strategies that also have often found it challenging to meet the repayment terms of the Standard Debenture.

In determining the maximum amount of SBA Leverage available to Accrual SBICs, SBA will aggregate the total principal Leverage plus ten years of accrued interest to determine the total Accrual Debentures that the Accrual SBIC may issue. For example, an SBIC with $100 million in Regulatory Capital[5] would generally be entitled to Debentures of up to $175 million. An Accrual SBIC with the same amount of Regulatory Capital, however, may be approved for only $118 million if, for example, the forecast interest would accrue to $57 million over a ten-year timeframe at a 4% interest rate (thus keeping the total amount guaranteed under the $175 million limit). Unlike SBICs with Standard Debentures, therefore, it is unlikely that larger Accrual SBICs will be eligible for two true tiers of Leverage.[6]

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[1] Proposed definitions in §107.50.

[2] SBA considered and ultimately rejected a zero-coupon instrument, i.e. an instrument that would be issued at a steep discount from face value that then matures over its term to full value.

[3] Among other definitional changes, SBA clarifies in the proposed rules that "Licensee," "SBIC" and "Small Business Investment Company" should have the same, interchangeable meaning.

[4] SBA would codify in proposed §107.865(f) an express restriction on Accrual SBICs holding more than 50% of a small business at an initial financing (unless the financing is to a relender or a reinvestor, given that an anchor investor of a fund, for example, may often initially hold more than 50% of a fund until subsequent closings occur).

[5] "Regulatory Capital" generally equals the SBIC's Private Capital, though SBA has discretion to exclude certain capital if SBA determines that the collectability of the commitment is questionable. "Private Capital" generally includes (i) the contributed capital of all of an SBIC's investors plus (ii) the aggregate unfunded binding commitments of the SBIC's Institutional Investors (subject to certain regulatory exemptions). "Institutional Investor" generally includes either (i) entities or individuals with a net worth of $10 million or (ii) individuals (A) with a net worth of $2 million, excluding the value of his or her most valuable residence and (B) at least 10 times the amount of his or her commitment to the SBIC (the 10x requirement does not apply to individuals with net worth of at least $10 million). Some entities, such as state entities, banks, insurance companies, benefit plans and tax-exempt foundations and trusts, are automatically deemed Institutional Investors.

[6] One tier of Leverage, under SBA regulations, is equal to 100% of the SBIC's Regulatory Capital. SBICs are generally limited to two tiers of Leverage (i.e. 200% of the SBIC's Regulatory Capital), capped for each SBIC at a maximum of $175 million.

II. Changes to READ and repayment of Leverage

SBA proposes significant changes to how SBICs are permitted to make profit distributions. Currently, SBA allows Leveraged Licensees to distribute "Retained Earnings Available for Distribution" (or READ) as profit distributions to its third-party investors. READ is generally calculated as the SBIC's undistributed net realized earnings, less any unrealized depreciations on loans and investments. In addition, until all Debentures have been repaid to SBA in full, an SBIC may only make distributions of up to 2.0% of Regulatory Capital in any given year, unless SBA approves a larger amount.

SBA's changes would generally require Leveraged Licensees to distribute far more capital to SBA much sooner as part of the Licensee's distributions waterfall (i.e. the priority of capital available to be distributed to investors).[7]

If adopted as proposed, SBA would require all Accrual SBICs, as well as SBICs with Standard Debentures licensed on or after October 1, 2023, to adopt a distribution waterfall that repays SBA the principal balance on outstanding Leverage on at least a pro rata basis with private investors. Therefore, if an SBIC has two tiers of

Leverage, with a precisely 2-to-1 ratio of Leverage to third-party equity, SBA would require $2 in distributions to be made to SBA for every $1 returned to the SBIC's investors.

The changes would exempt existing SBICs and any SBICs (other than Accrual SBICs) licensed prior to October 1, 2023, which would continue to be subject to the current rules. SBA also proposes a carveout (even after October 1, 2023) from the new rules for SBICs wholly owned by business development companies (BDCs), which are required to distribute profits to investors.

SBA explained the proposal in terms of its concern that SBICs may distribute profits without repaying Leverage, especially in the context of equity investors that may have less consistent returns than private creditor or mezzanine funds. An SBIC could return early profits to its investors, only to incur losses on written-down or written-off assets later in the fund's life.

SBA would continue to allow Non-leveraged Licensees far more discretion with respect to distributions, given that there is no credit risk to SBA. The proposed rules would continue to allow them to distribute to their private investors without SBA prior approval so long as they meet sufficient regulatory minimum capital requirements, unless such other amounts are in accordance with their SBA-approved Wind-down Plan.[8]

III. Facilitating investment in underserved communities

SBA would introduce a new definition, "Underlicensed State," defined as a U.S. state (or territory) where the number of operating Licensees per capita is fewer than for the median number for all U.S. states and territories; SBA would publish the list of Underlicensed States periodically on the SBIC website.[9]

In particular, SBA proposes to give priority to license applicants that are (i) headquartered in Underlicensed States that (ii) are also states that have below median SBIC financing dollars (as determined by SBA).[10]

SBA is currently permitted to lower its requirement of at least $5 million in Regulatory Capital to just $3 million, in SBA's sole discretion and based on special circumstances and good cause, if the applicant (i) meets its licensing standards with the exception of minimum capital, (ii) has a viable business plan reasonably projecting profitable operations; and (iii) has a reasonable timetable for achieving Regulatory Capital of at least $5 million.[11] SBA proposes to specify that one example of "good cause" would be that the applicable Licensee is headquartered in an Underlicensed State, indicating that SBA may be more willing in future to lower the $5 million requirement. Note, however, that excepted Licensees would only be entitled to up to one tier of Leverage (i.e. 100% of Regulatory Capital) until such time as they raise $5 million in Regulatory Capital.[12]

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[7] Proposed §107.585.
[8] Proposed §107.585(a).
[9] Proposed definition in §107.50.
[10] Proposed §107.300.
[11] Proposed §107.210(a)(1).
[12] Proposed §107.1120(c)(1) and §107.1150(a)(2).

Furthermore, SBA currently reserves the right to maintain diversification among "early-stage SBICs" (a category of SBIC in which SBA no longer issues new licenses) with respect to (i) the year they commence operations and (ii) their geographic location. SBA proposes to broaden this evaluation discretion by reserving SBA's right Proposed §107.300. to maintain diversification among all Total Leverage Commitments on the basis of (i) the year in which they commenced operations, (ii) their geographic location (with first priority to applicants from Underlicensed States that also have below median SBIC financing dollars per state) and (iii) asset class and investment strategy.[13]

Finally, while SBA does not permit SBICs to finance businesses that are relenders or reinvestors, SBA currently provides for an exemption to certain Disadvantaged Businesses. SBA proposes to replace this exemption and allow for SBICs to provide Equity Capital Investments to "underserved" relenders or reinvestors that make financings solely to small businesses eligible to receive direct financing from an SBIC.[14] In some cases, this would allow certain SBICs to act more like funds-of-funds, provided that the underlying funds are "underserved" and otherwise meet the SBIC program's criteria for investment, i.e., that the funds invest only in small businesses that an SBIC would be permitted to invest in directly.

IV. Changes to SBIC reporting

Taken together, SBA proposes to make several changes, substantially and procedurally, to SBIC reporting.

— **Use of GAAP in valuation policy.** Currently, Licensees must prepare and maintain a valuation policy, approved by SBA, for use in determining the value of the SBIC's investments. To that end, current regulations require SBICs to use the model valuation policy in SBA's Valuation Guidelines for SBICs, unless otherwise approved by SBA. In many cases, however, private equity funds prepare valuations in accordance with generally accepted accounting principles (GAAP), as established by the Financial Accounting Standards Board, and many SBIC investors also require GAAP reporting. This often requires SBICs to maintain two sets of valuations. SBA proposes that Non-leveraged Licensees may adopt a valuation policy in accordance with GAAP, thereby lowering their regulatory burden.[15] This change codifies existing policy and reduces uncertainty about what financials may be required.

— **Quarterly reporting.** SBA proposes that all Leveraged Licensees value their loans and investments quarterly (rather than semi-annually), in line with quarterly reporting required by Form 468.[16] All Licensees, however, must report valuations at least annually. Under the proposed changes, however, Leveraged Licensees would have 45 days to complete their quarterly valuation reporting.17 In a conforming change, Form 468 would be required to be submitted within 45 days following the end of the fiscal quarter (increased from 30 days).[18]

— **Portfolio financing reports.** Licensees are currently required to submit Form 1031 within 30 days of the closing date of the financing. SBA proposes instead that Licensees make quarterly reports, such that they would report the portfolio financing within 30 days of the quarter end following the closing date of the financing.[19] This would allow licensees to submit Form 1031s for all investments made within that quarter at the same time.

— **Annual reporting.** SBA requires all Licensees to submit their financial statements and supplementary information annually, prepared as part of Form 468. In a conforming change to SBA's proposed changes to valuations, Form 468 would be required to be submitted within 90 days following the end of the fiscal year (and not on or before the last day of the third month following the end of the fiscal year, as is currently required).[20] In addition, Form 468 currently requires an assessment of the economic impact of each

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[13] Proposed §107.320.
[14] Proposed §107.720(a)(2).
[15] Proposed §107.503(b).
[16] Proposed §107.503(d) and §107.650.
[17] Proposed §107.650.
[18] Proposed §107.1220.
[19] Proposed §107.640.
[20] Proposed §107.630(a).

financing, including the impact of the financing on revenues and profits of the business and taxes paid by the business and its employees, as well as full-time equivalent jobs created or retained. SBA proposes adding "total jobs created or retained" (including both full-time and part-time jobs) as well, along with a breakdown of the number of jobs added through organic growth and acquisitions.[21] SBA also proposes requesting, on a voluntary basis, certain demographic information with respect to the portfolio concern's ownership.[22] At the fund level, SBA proposes requiring Licensees to provide updated management contact information for the SBIC's principals, CFO and other key contacts, and also requests demographic information for the same individuals on a voluntary basis.[23]

— **Other reporting items.** SBA regulations currently require that Licensees provide SBA a copy of any report they also provide to their private investors. SBA proposed to clarify that such reports must be provided no later than 30 days after the date such report was sent to private investors.[24]

V. Revisions to fees and Annual Charge

SBA proposes significant changes to how it charges (i) Licensing Fees from applicants for SBIC licenses, (ii) examination fees and (iii) the additional Annual Charge that SBICs pay.

Licensing Fees

Effective from October 1, 2022, the Initial Licensing Fee (payable with the submission of the management assessment questionnaire or "MAQ") is $11,500 and the Final Licensing Fee (payable with the submission of the full application following a "green light letter" from SBA) is $40,200, each adjusted annually for inflation.

SBA instead proposes to revise the Licensing Fee based on an SBIC's fund sequence to a fixed fee between $5,000 and $20,000, whereby a first-fund SBIC pays a smaller Initial Licensing Fee than a second fund (and so on, until the fourth fund, as shown below).[25] Thereafter, the Final Licensing Fee would equal the sum of (i) a Final Licensing Base Fee (again increasing through the fourth fund) plus (ii) 1.25 basis points multiplied by the Leverage dollar amount requested by the applicant.[26]

Fund Sequence	Initial Licensing Fee	Final Licensing Base Fee	Total Base	Total Licensing Fee (based on $175M in Leverage)
Fund I	$5,000	$10,000	$15,000	$36,875
Fund II	$10,000	$15,000	$25,000	$46,875
Fund III	$15,000	$25,000	$40,000	$61,875
Fund IV+	$20,000	$30,000	$50,000	$71,875

In addition, SBA proposes an application resubmission penalty fee of $10,000 for an applicant that has previously withdrawn or otherwise is not approved for a license, in addition to the Initial and Final Licensing Fees.

Examination Fees

Currently, SBA charges an examination fee based on a formula of a minimum base fee plus 0.024% of assets at cost, up to a set maximum fee, while Non-leveraged Licensees currently pay a lower examination fee.

[21] Proposed §107.630(d).
[22] Proposed §107.620(b)(2).
[23] Proposed §107.630(e).
[24] Proposed §107.660.
[25] Proposed §107.300(c)(1). The proposed rule does not specify whether a "first fund" means a management team's first SBIC or first fund of any type.
[26] Proposed §107.300(c)(2).

SBA proposes instead a simpler formula, such that each SBIC pays $10,000 plus 0.035% of Total Leverage Commitment (a new definition introduced by SBA, discussed below, that equals the full SBA Leverage commitment over the life of the SBIC).[27] In the interim, for existing Licensees (until after any proposal rule is adopted), the formula would be based on 0.035% of the sum of (i) outstanding Leverage plus (ii) SBA's undrawn commitment amount. For Non-leveraged Licensees, the new formula would result in a flat examination fee of $10,000. Given that SBA incurs more costs based on the assets of a Licensee, however, SBA proposes charging a flat fee of $30,000 for those Non-leveraged Licensees with $50 million or more in assets (valued at cost).

Type of Licensee	Existing Licensees	Future Licensees
Leveraged	$10,000 plus 0.035% of sum of (i) outstanding Leverage plus (ii) SBA's undrawn commitment amount	$10,000 plus 0.035% of Total Leverage Commitment
Non- leveraged (under $50 million in assets at cost)	$10,000	$10,000
Non-leveraged (over $50 million in assets at cost)	$30,000	$30,000

Annual Charge

Finally, SBA would codify a minimum Annual Charge of 0.50% or 50 basis points.[28]

The Annual Charge, which SBA caps at a maximum of 1.00%, has trended downward in recent years, to an all-time low of 0.047% in FY 2023. While the minimum 0.50% Annual Charge would be the highest Annual Charge that SBA has charged since FY 2016, and nearly 10 times the Annual Charge in FY 2023, SBA argues that the fiscally responsible administration of the SBIC program requires a minimum charge robust enough to address long-term variances in losses and to preserve a zero or negative subsidy cost to the program.

VI. Use of credit lines without SBA approval

SBA currently requires SBICs to obtain prior SBA approval for secured third-party debt for Leveraged Licensees (but not for Non-leveraged Licensees).

The proposed rule, however, would allow Leveraged Licensees to use a secured "Qualified Line of Credit," subject to several conditions and qualifications, without prior SBA approval, thereby streamlining a common practice for many private funds, including SBICs.[29]

The qualifications, as proposed, are as follows:

1. The line of credit must be limited to 20% of total unfunded binding commitments from Institutional Investors;
2. The term of the line of credit must not exceed 12 months (though lines of credits that are renewable on an annual basis would be acceptable);
3. The line of credit must be held by a federally regulated financial institution; and
4. All borrowings must meet the following four conditions:

i. Are only secured by unfunded Regulatory Capital up to 100 percent of the amount of the borrowing plus 90 days of interest;

[27] Proposed §107.692(b).
[28] Proposed §107.1130(d)(1).
[29] Proposed §107.550(c).

ii. Are for the purpose of maintaining the SBIC's operating liquidity or providing funds for a particular financing or small business;

iii. Must be fully repaid within 90 days after the date they are drawn; and

iv. Must be fully paid off for at least 30 consecutive days during the SBIC's fiscal year so that outstanding third-party debt is zero for at least 30 consecutive days.

According to SBA, the proposed rule would provide an exemption for most instances of third-party debt that SBA would likely approve. For this reason, SBA proposes eliminating certain existing conditions for SBA approval. In addition, under the current regulations, a request for approval of a line of credit is deemed approved after 30 days unless SBA notifies the SBIC otherwise in advance of that deadline. SBA proposes eliminating this automatic approval feature in the current regulations.

Finally, under this new rule, unsecured lines of credit will continue to not require SBA consent. Whether or not a line of credit is, in fact, secured or unsecured is not further clarified under the new proposed rule.

VII. Additional revisions

The proposed rules contain a significant number of additional important revisions, many of which , will be of interest to many Licensees, investors and those who may seek SBIC licenses or seek to make SBIC investments in the future. Some of these are described below.

- **Total Leverage Commitment.** SBA proposes the new definition "Total Leverage Commitment," which would include the total SBA Leverage commitments available to a Licensee over the life of the SBIC.[30] In one of the most significant changes to existing practice, SBA proposes to approve the Total Leverage Commitment as part of the final licensing process, rather than allow for additional Leverage commitments through the investment period of the fund. This potentially represents an abrupt change from existing practices for many SBICs, as it would appear to require an SBIC to hold its final equity closing for third-party investors in connection with licensing or forgo Leverage on capital raised post-licensing. SBA intends that this change will (i) reduce the burden associated with separate commitment requests performed after the SBIC has been licensed and (ii) reduce the uncertainty regarding SBA's leverage commitment and thereby reduce the private capital timeframe for prospective Licensees. SBA has indicated informally that this change is not intended to require SBICs to forgo Leverage on capital raised post-licensing, and accordingly, there may be revisions to the proposal before it is finalized.
- **Definition of "Associate".** SBA proposes to revise the definition of "Associate" regarding the status of an entity Institutional Investor based on its ownership interest in an SBIC. Currently, an entity Institutional Investor whose ownership represents over 33% of the SBIC's Private Capital is an Associate; SBA proposes to change this to 50%.[31] This change would give SBICs somewhat greater flexibility to invest in a portfolio company in which a large institutional investor also has a pre-existing equity interest without obtaining a conflict of interest waiver from SBA. If SBA changes its licensing policies to conform to this proposed definitional change, it would also allow a large institutional investor to provide up to 50% of the SBIC's Private Capital without having to meet SBA's fingerprinting and other disclosure requirements. Such a change could result in more concentrated fundraisings by SBICs.
- **Non-profit exemption from diversification requirement.** Generally, no person or group of affiliated persons is permitted to own or control, directly or indirectly, more than 70 percent of an SBIC's Regulatory Capital or Leverageable Capital.[32] The current regulations provide an exception for Traditional Investment Companies, defined as professionally managed for-profit firms organized exclusively to pool capital from multiple sources, for the purpose of investing in businesses that are expected to generate significant financial returns to the firm's investors. SBA proposes to expand the Traditional Investment Company definition to

[30] Proposed §107.300(b).
[31] Proposed definitions in §107.50.
[32] "Leverageable Capital" is equal to Regulatory Capital, excluding unfunded investor commitments.

include non-profit entities that otherwise meet the criteria.[33] This would, in SBA's view, facilitate capital raising efforts, particularly for first-time funds and funds targeting investment in underserved geographies and critical technologies. Although this change would allow a qualifying non-profit to own more than 70% of an SBIC's capital, the SBIC itself would still have to be a for-profit entity.

— **Evaluation qualifications.** In evaluating applicants to the SBA program, SBA considers, among other qualifications, the managers' prior investment performance, demonstrated investment skills and experience and successful history of working as a team. SBA proposes that, in addition to the existing criteria, SBA will also consider (i) relevant industry operational experience, which may be combined with investment skill to demonstrate managerial capacity and (ii) as applicable, the applicant's experience in managing a regulated business, including past adherence to statutory and regulatory SBIC program requirements.[34] The former change broadens the criteria to include operational experience which may allow SBA more flexibility in licensing first-time sponsors, in particular.

— **Technology requirements.** In line with technological advances, SBA would eliminate the requirement that SBICs must have a personal computer with a modem and facsimile capability; instead, SBICs must have technology to securely send and receive emails, scan documents and prepare and submit electronic information and reports required by SBA.[35]

— **Safe harbor from conflicted investments.** SBA currently prohibits Licensees from transactions that constitute conflicts of interest, including financing to a Licensee's Associate (which includes, among other things, any concern in which an affiliated fund owns or controls an equity interest of 10% or more). Currently, SBA provides for a narrow exemption from this rule; SBA proposes expanding the safe harbor to those instances where an independent third party (i) is investing in the small business at the same time and on the same terms and conditions and (ii) represents a significant portion of the financing.[36] SBA has not defined what would constitute a "significant portion."

— **Capital impairment.** SBA currently requires Leveraged Licensees to calculate their capital impairment percentage (CIP) and report to SBA if the SBIC meets a condition of capital impairment. SBA proposes that, in the future, SBA (and not the Licensee) will calculate the Licensee's CIP each quarter and notify the SBIC if the SBIC is capitally impaired.[37] SBA also proposes to amend the regulations defining how to compute a Licensee's CIP to specify that SBA would perform the computations. There would be no substantive change in the CIP formula.[38]

— **Enhanced monitoring.** SBA proposes to introduce a special Enhanced Monitoring status in an effort to identify and manage risk.[39] SBA would cause a Licensee to have Enhanced Monitoring status for a series of actions, including:

1. a key person event pursuant to the SBIC's limited partnership agreement (LPA);
2. a direct violation of the SBIC's stated investment policy as identified in its LPA or as presented to SBA in its license application;
3. the SBIC or its general partner has been named as a party in litigation proceedings;
4. the SBIC has violated a material provision in its LPA or any side letter;
5. bottom quartile performance for the SBIC's primary benchmark and vintage year after three years based on the private investor's Total Value to Paid-in-Capital;[40]

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[33] Proposed §107.150(b).
[34] Proposed §107.305.
[35] Proposed §107.504(a)-(b).
[36] Proposed §107.730(a)(1).
[37] Proposed §107.1830(e).
[38] Proposed §107.1840 and 107.1845.
[39] Proposed §107.1850.
[40] TVPI is calculated as cumulative distributions to private investors plus net asset value minus expenses and carried interest) / cumulative private investor paid in capital, where net asset value is based on GAAP valuations.

6. the SBIC's Leverage Coverage Ratio (LCR) falls below 1.25;[41] or
7. the SBIC defaults on its interest payment and fails to pay within 30 days of the date it is due.

Among other things, an SBIC in Enhanced Monitoring may have to participate in monthly SBA portfolio reviews, file quarterly valuation reports on specific or all portfolio company holdings, and file SBA Form 1031 more often than quarterly.

— **Company Act considerations and affiliation rules.** In 13 CFR §121, SBA sets forth size standards and defines a business's size to include the size of their affiliates, subject to certain exceptions. One such exception applies only to financial, management and assistance under the SBIC Act and is intended to exclude "Traditional Investment Companies" from affiliation coverage, as well as private funds exempt from registration under Section 3(c)(1) under the U.S. Investment Company Act of 1940 (the Company Act), which exempts entities owned by less than 100 persons. SBA's intention was to allow SBIC financings with private equity or other types of funds, given the common market practice of co-investment and syndication among such funds, allowing for the deployment of greater capital to small businesses. Private funds, however, often rely on Section 3(c)(7) as well, which exempts entities whose owners are entirely "qualified purchasers." SBA proposes to add investment companies exempt from registration under Section 3(c)(7) in a bid to modernize its regulations.[42] The change would provide significant relief and clarity to SBICs in applying the SBA size standards when investing in sponsored transactions.

— Finally, there are several additional proposed changes that, among other things, reflect the end of the Participating Securities instrument, a prior program designed to support equity investors (which SBA has not authorized since 2004), removing references to the Participating Securities program as applicable. Other changes are definitional, such as changing the term "Wind-up Plan" to "Wind-down Plan."

VIII. Conclusion

The cumulative effect of the SBA proposals will have a broad and meaningful impact on the SBIC program, including for current and future SBICs operating with respect to Standard Debentures, and for those fund sponsors who may be interested in pursuing SBIC licenses in the future, especially with regard to the proposed new Accrual Debenture instrument.

We continue to monitor ongoing SBA rulemaking, including through the December 19 deadline for comments, and we will provide updates as additional proposals emerge and when SBA adopts final rules regarding one or more of the proposals described herein.

[41] LCR is calculated as (unfunded Regulatory Capital commitments plus net asset value minus outstanding Leverage) / outstanding Leverage.
[42] Proposed §121.103(b)(5)(vi).

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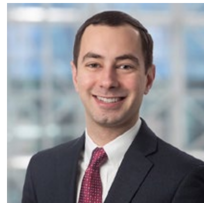

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