This is a commercial communication from Hogan Lovells. See note below.

SBA finalizes significant reforms to SBIC program

Changes introduce new Accrual SBIC for equity investors and a Reinvestor SBIC for funds-of-funds

The U.S. Small Business Administration (SBA) finalized wide-ranging revisions to the regulations governing the small business investment company (SBIC) program on Thursday, July 13, 2023. Among other things, the changes introduce a new type of Accrual Debenture, issued at face value that will accrue interest over a ten-year term and is designed to attract venture and growth equity investors as well as funds-of-funds into the SBIC program. Additional revisions aim to (i) modernize licensing and leverage commitment processes, (ii) update licensing fee structures, (iii) facilitate investment by first-time SBIC sponsors and those who invest in underserved communities, (iv) revise certain reporting and valuation standards, and (v) codify or clarify long-standing informal SBA practices and interpretations. The regulations make nearly three dozen revisions to 13 CFR §107 and §121, and taken together, represent the most significant regulatory changes to the SBIC program in a quarter of a century. The regulations will be effective August 17, 2023.

SBA's rationale for many of the new 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.

The full text of the final rule is available here. These regulatory changes will be effective August 17, 2023.

I. Accrual Debentures available to broad range of funds, including venture capital, growth equity, buyout and fund-of-funds

The final rule establishes a new type of debenture, the "Accrual Debenture," which would be available to "Accrual SBICs" and "Reinvestor SBICs" (discussed in Section III). The Accrual Debenture is designed to align with the cash flows of primarily equity-oriented funds.[1] Overall, the Accrual Debenture rule is substantially similar to the proposed rule with a few key differences discussed below, including (i) the removal of strategy requirements for Accrual SBICs, (ii) a cap on leverage for Accrual SBICs at 1.25x, and (iii) the permissibility of tax distributions.

Accrual Debentures will be issued at face value and accrue interest over their ten-year term.[2] As is the case with Standard Debentures, Accrual Debentures must be repaid at their ten-year maturity and may be prepaid at any time. In a notable departure from the proposed rule, the definition of "Accrual Debenture" no longer includes the flexibility for a Licensee[3] to apply for a five-year rollover to extend the term of the Accrual Debenture for another five years.

1 §107.50.
2 SBA considered and ultimately rejected a zero-coupon instrument.
3 SBA clarifies in the final rule that "Licensee," "SBIC" and "Small Business Investment Company" have the same, interchangeable meaning in the regulations.

Consistent with the regulations prior to the final rule, the Standard Debenture available under the SBIC program provides for ten-year maturity, with interest due and payable on a semi-annual basis. As SBA notes in its adopting release, this structure works well for certain investment funds, such as credit funds, that expect to have consistent cash flow over the term of the fund (such as interest payments or loan repayment). Consequently, the vast majority of SBIC financings are currently debt-focused investments and not equity-focused investments. Cash flows for equity-focused funds are generally less predictable, with monetization often occurring only upon sale, recapitalization or other disposition of the equity investment.

With the introduction of the Accrual Debenture instrument, SBA aims to encourage more SBIC investments across a significantly expanded set of private fund strategies. The proposed rule required Accrual SBICs generally to be minority equity investors.[4] Significantly, the final rule simplifies the definition of "Accrual SBIC" by eliminating these requirements. "Accrual SBIC" is defined simply as "a Section 301(c) Partnership Licensee, licensed under § 107.300 and approved by SBA to issue Accrual Debentures." This change is among the more important changes between the proposed rule and final rule because it significantly expands the subset of private fund strategies for which the Accrual Debenture structure will align. Those strategies now include buyout funds, credit funds, and funds-of-funds (which can be licensed as Reinvestor SBICs) in addition to the previously covered strategies of venture and growth equity. This key change addresses the long-standing hurdle faced by certain fund sponsors that have often found it challenging to meet the repayment terms of the Standard Debenture.

The final rule also limits Accrual SBICs to a maximum of 1.25 tiers of Leverage, significantly less than the 2 tiers for which most Standard Debenture SBICs are eligible. This change is designed to mitigate risk to SBA.

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 an Accrual SBIC may issue. For example, a Standard Debenture SBIC with $100 million in Regulatory Capital[5] would generally be entitled to Debentures of up to US$175 million, the maximum amount currently available to an individual SBIC. An Accrual SBIC with the same amount of Regulatory Capital, however, may be approved for only US$118 million in Leverage principal if, for example, the forecasted interest would accrue to US$57 million over a ten-year term (thus keeping the total amount of leverage capped at the maximum allowable statutory limit).

II. A New Distribution Regime for Accrual SBICs and Reinvestor SBICs

Currently, Standard Debenture SBICs may distribute "Retained Earnings Available for Distribution" (or READ) as profit distributions without making concurrent payments to SBA. 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 also make distributions of up to 2.0% of Regulatory Capital in any given year, unless SBA approves a larger amount. In response to comments, SBA did not adopt any changes to this distribution regime.[6]

The final rule, however, implements a distribution waterfall for Accrual SBICs and Reinvestor SBICs that, unlike the requirements for Standard Debentures, requires repayment to SBA of the principal balance on outstanding Leverage on at least a pro rata basis with private investors. Therefore, if an Accrual Debenture SBIC has 1.25 tiers

4 The proposed definition of "Accrual SBIC" had incorporated a requirement to invest (i) at least 75% of its total financings (based on dollar amount) in equity and equity-like investments and (ii) in no more than 50% of the small business concern at initial financing.

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. Revisions to the definition of Regulatory Capital are discussed in Section VIII below.
"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 §107.585(b).

of Leverage, SBA would require $1.25 in distributions to be made to SBA for every $1 distributed to the SBIC's investors.[7]

In more detail, Accrual SBICs and Reinvestor SBICs will be required to make distributions according to the following waterfall:

a. payment of Annual Charges and accrued interest on outstanding Leverage;[8]

b. calculate SBA's Share based on the ratio of SBA's Total Intended Leverage Commitment[9] and Total Private Capital Commitments,[10] inclusive of Qualified Non-Private Funds, determined within 12 months of Licensure established as follows: SBA's Share = Total Distributions[11] x [Total Intended Leverage Commitment / (Total Intended Leverage Commitment + Total Private Capital Commitments)];[12]

c. repay outstanding SBA Leverage in an amount no less than SBA's Share to the extent of Outstanding Leverage. If SBA's Share is greater than Outstanding Leverage held by the Licensee and the Licensee has unfunded Leverage Commitments, the Licensee must submit a Leverage Commitment cancellation equal to SBA's Share minus SBA Leverage redemptions; [13]

d. distribute to private investors the remaining amount;[14] and

e. report the distribution to SBA on Form 468 quarterly and annual submissions.[15]

Importantly, in the final rule, SBA clarified that tax distributions are permitted with prior approval from SBA.[16] Prior to any reduction in Regulatory Capital, however, if a Licensee has made a tax distribution, the Licensee must first make a distribution to SBA pursuant to the above formula as if the Licensee had made a non-tax distribution.[17] It's also worth noting that although the preamble text to the final rule provides that Accrual SBICs will not be permitted to make distributions within 12 months of licensure, this limitation does not appear in the text of the final rule.

SBA's rationale for mandating this distribution waterfall was its concern that Accrual Debenture SBICs may distribute profits without repaying Leverage, especially in the context of equity investors that may have less consistent returns than credit funds. An Accrual SBIC or Reinvestor 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 will continue to allow Non-leveraged Licensees far more discretion with respect to distributions, given that there is no credit risk to SBA.[18] The final rule will continue to allow Non-leveraged Licensees to make distributions that reduce Regulatory Capital to their private investors without SBA prior approval so long as they meet statutory minimum capital requirements or are operating in accordance with their SBA-approved Wind-up Plan.[19]

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7 §107.585(c).

8 §107.585(c)(1).

9 "Total Intended Leverage Commitment" defined as "the dollar amount or ratio of SBA Leverage commitments to Private Capital commitments. The final Total Intended Leverage Commitment dollar amount applied in the Accrual Debenture SBA Share calculation will be finalized no later than 12 months after licensure or upon the Licensee's final close, whichever occurs first." §107.300(b), citing §107.50.

10 "Total Private Capital Commitment" is defined as "the total Private Capital committed to a Licensee within 12 months after licensure or upon the Licensee's final closing, whichever occurs first." §107.300(b).

11 "Total Distributions" defined as "the total amount of distributions (whether profit or return of capital) [the SBIC] intend[s] to make after paying all accrued interest and Annual Charges plus any prior tax distributions." §107.585(c)(2)(i).

12 §107.585(c)(2).

13 §107.585(c)(3).

14 §107.585(c)(4).

15 §107.585(c)(5).

16 §107.585(c).

17 §107.585(c)(4).

18 §107.585(a).

19 As expected, SBA changed the term "Wind-up" Plan to "Wind-down" Plan throughout 13 CFR §107 to better reflect the wind-down of a fund at the end of its life cycle.

III. Facilitating investment in underserved communities; Reinvestor SBICs

One of the stated purposes of the final rule is to reduce barriers for participation in the SBIC program for "underserved communities and geographies." A few key changes relate to that goal.

The most significant change in this regard is the creation of a fund-of-funds SBIC now defined as a "Reinvestor SBIC." [20] Reinvestor SBICs are SBICs permitted to issue Accrual Debentures that must comply with the general requirements for Accrual SBICs described above. Notably, SBICs that do not seek leverage are not permitted to be Reinvestor SBICs under the final rule.

SBA created the Reinvestor SBIC as an exception to the general prohibition on SBIC investments in relenders or reinvestors.[21] Key criteria for Reinvestor SBICs include:

1. a Reinvestor SBIC must provide a "meaningful percentage" of "Equity Capital Investments"[22] to underserved small business reinvestors (excluding banks, savings and loans companies not insured by the federal government and agricultural credit companies);
2. the underlying reinvestor (i.e., the fund in which the Reinvestor SBIC will invest) must make investments in small businesses that have at least 50% of their employees in the United States, are headquartered in the United States, are owned and controlled by U.S. citizens and/or entities and that meet the size standards under the SBIC regulations;
3. SBA may require that a Reinvestor SBIC receive written confirmation that the underlying fund in which the Reinvestor SBIC invests will comply with the requirements described in paragraph (2) above and will provide the Reinvestor SBIC with information necessary to confirm that it is complying with those requirements.[23]

Unlike the proposed rule, which capped investments in underlying funds at 100% of Regulatory Capital (which, for example, would be 50% of a Reinvestor SBIC's total capital if levered on a 1:1 basis), there is no limit on the amount of capital that a Reinvestor SBIC may invest into underlying funds.[24] In addition, the underlying funds are now only required to ensure that the underlying portfolio companies satisfy the criteria enumerated above. They are no longer required to ensure that the underlying portfolio companies satisfy all of the requirements of the SBIC regulations as originally proposed.[25]

A key component of the Reinvestor SBIC is that the underlying funds in which the Reinvestor SBIC invests must be "underserved." SBA did not define "underserved," but stated in the adopting release that it intends to take a broad view of the meaning of "underserved" so as to "maintain flexibility and agility to align with evolving market conditions." Underserved funds are likely to include funds managed by investment firms that are minority, women and/or veteran owned, as well as firms that are located in geographies that are not traditionally well served by SBICs or the private investment community. SBA may approve SBICs with other "underserved" funds as well.

In addition to the Reinvestor SBIC, the final rule includes several other changes related to the goal of expanding access to underserved populations and geographies.

The final rule restored a pre-existing exception to the prohibition on investments in reinvestors and relenders to allow SBICs to invest in disadvantaged business that are reinvestors or relenders (e.g., minority-owned banks).[26]

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20 §107.50; §107.720(a)(2).
21 §107.720(a).
22 "Equity Capital Investments" is defined as "investments in a Small Business in the form of common or preferred stock, limited partnership interests, options, warrants, or similar equity instruments, including subordinated debt with equity features if such debt provides only for interest payments contingent upon and limited to the extent of earnings. Equity Capital Investments must not require amortization. Equity Capital Investments may be guaranteed; however, neither Equity Capital Investments nor such guarantee may be collateralized or otherwise secured. Investments classified as Debt Securities (see §§ 107.800 and 107.815) are not precluded from qualifying as Equity Capital Investments."
23 §107.720(a)(2)(i).
24 §107.720(a)(2)(i).
25 §107.720(a)(2)(i).
26 §107.720(a)(2)(ii).

Consistent with the proposed rule, the final rule adds 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 will publish the list of Underlicensed States periodically on the SBIC website.[27]

This is in compliance with the U.S. Spurring Business in Communities Act of 2017 and is also generally consistent with SBA's current practice. The new rule gives 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).[28]

Consistent with the regulations prior to the final rule change, SBA is permitted to lower its requirement of at least $5 million in Regulatory Capital to $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.[29]

SBA specified that one example of "good cause" would be that the applicable Licensee is headquartered in an Underlicensed State[30], indicating that SBA may be more willing in the future to lower the $5 million requirement. In addition, in the adopting release SBA stated that the "good cause" exception is not solely based on geography. Note, however, that excepted Licensees are only eligible for up to one tier of Leverage (i.e., 100% of Regulatory Capital) until such time as they raise $5 million in Regulatory Capital.[31]

Furthermore, SBA previously reserved 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. As revised, SBA broadens this evaluation discretion by reserving SBA's right to maintain diversification among all leveraged licensees 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.[32]

IV. Changes to the SBIC licensing process

The final rule seeks to streamline the licensing rules and related leverage commitment rules to lower costs and administrative barriers faced by new funds applying to the SBIC program. In addition to the changes discussed above to prioritize applicants in Underlicensed States, SBA (i) expanded the requirements to be a qualified SBIC manager, (ii) simplified the leverage commitment process and (iii) created an expedited licensing process for certain, qualifying subsequent funds.

In evaluating applicants to the SBIC program, SBA considers, among other qualifications, the managers' prior investment performance, demonstrated investment skills and experience and successful history of working as a team. In addition to the existing criteria, SBA will now consider (i) relevant industry operational experience, which may be combined with investment skill to demonstrate managerial capacity and (ii) as applicable, the managers' experience in managing a regulated business, including past adherence to statutory and regulatory SBIC program requirements.[33] The former is an important change. SBA has indicated that an experienced investment professional partnering with someone with operational experience in the target industry of an applicant will be viewed favorably. In contrast, the current regulations require at least two experienced professionals with the requisite investment experience to manage an SBIC. This has been a significant hurdle for many potential SBIC applicants.

In the proposed rule, SBA intended to simplify the leverage commitment process, which currently is an entirely separate process from the licensing process. At the time of the proposed rule, however, it was unclear whether SBICs had to hold their final fund closing in connection with licensing or otherwise forego Leverage on capital raised post-licensing. SBA has clarified this by adding a new definition for "Total Intended Leverage

27 §107.50.
28 §107.300.
29 §107.210(a)(1).
30 §107.210(a)(1).
31 SBIC Act §301(c)(4)(B)(iii).
32 §107.320.
33 §107.305.

Commitment," meaning the dollar amount or ratio of SBA Leverage Commitments to Private Capital that SBA will approve in an applicant's green light letter. [34] Once licensed, an SBIC will now have 12 months to raise the private capital necessary to access the entire Total Intended Leverage Commitment. Another new definition for "Total Leverage Commitment" represents this "final" amount (i.e., the total SBA Leverage commitments available to a Licensee over the life of the SBIC).[35]

In response to comments on the proposed rule, SBA is introducing a new expedited and streamlined licensing process for management teams that already operate one or more licensed SBICs.[36] Applicants that meet each of the eligibility criteria described below may now submit a "Short-Form Subsequent Fund MAQ" and participate in the expedited licensing process.[37] The relevant criteria are:

1. the applicant's targeted Regulatory Capital is less than or equal to 133% of the size of the most recent SBIC fund and the asset class and investment strategy are the same as the most recent SBIC fund;
2. there have been no major findings or significant or unresolved "other matters" in the previous 10 years related to SBIC funds managed by the same principals;
3. no new limited partner will represent more than 33% of Private Capital upon the final closing, and the two largest investors in the most recent SBIC fund have verbally committed to invest in the applicant;
4. there will be no substantive changes to the applicant's partnership agreement and side letters;
5. for the most recent SBIC fund, net distributions to paid-in capital (DPI) / Total Value to Paid-in-Capital (TVPI)[38] are at or above median vintage and strategy performance benchmarks and the principals are not managing another SBIC fund that is in default or has high capital impairment;
6. requested Leverage will be at or below the level of the most recent SBIC fund;
7. there have been no material changes to the firm (e.g., personnel changes related to the applicant);
8. management has demonstrated commercially reasonable efforts to promote internal investment team talent from within the organization;
9. management has demonstrated commercially reasonable efforts to share carried interest and/or management company economics with promoted talent or otherwise distribute economics equitably among the investment team;
10. the sponsoring entity and principals do not have an FBI criminal record or any IRS violations since the date of the most recent SBIC fund's licensure;
11. there are no outstanding litigation matters involving allegations of dishonesty, fraud, breach of fiduciary duty or anything that would be required to be reported under §107.660(c) or (d) that are related to the applicant; and
12. the sponsoring entity, most recent SBIC fund and the principals do not have any outstanding tax liens.

XIII. Changes to SBIC reporting

Taken together, the final rule makes several changes, substantially and procedurally, to SBIC reporting. In general, these changes are consistent with the proposed rule with minor clarifications and additional commentary.

- **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 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. Consistent with the proposed rule, the final rule allows Non-leveraged Licensees to adopt a

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34 SBA issues the green light letter following SBA's review of the management team and its financial and regulatory history, often including an interview of the management team. The green light letter is a formal invitation to file a full license application once the Applicant has completed its initial fundraising. §107.300(b).

35 §107.300(b).

36 §107.305(e).

37 MAQ stands for Management Assessment Questionnaire. It is the initial stage of the SBIC licensing process.

38 TVPI is calculated as (cumulative distributions to private investors plus net asset value minus expenses and carried interest) / cumulative private investor paid in capital.

valuation policy in accordance with GAAP, thereby lowering their regulatory burden.[39] This change codifies existing policy and reduces uncertainty about what financials may be required.

- **Quarterly reporting.** Consistent with the proposed rule, the final rule requires that all Leveraged Licensees value their loans and investments quarterly (rather than semi-annually), in line with quarterly reporting required by Form 468.[40] All Licensees, including Non-leveraged Licensees, must report valuations at least annually. As in the proposed rule, however, the final rule gives Leveraged Licensees 45 days after the close of each quarter to complete their quarterly valuation reporting.[41] In a conforming change, Form 468 will be required to be submitted within 45 days following the end of the fiscal quarter (increased from 30 days).[42] Quarterly reporting will be limited to a "short form" version of the Form 468.
- **Portfolio financing reports.** Licensees are currently required to submit Form 1031 within 30 days of the closing date of each financing. The proposed rule and now the final rule stipulate that Licensees make quarterly submissions of Form 1031, such that they would report the portfolio financing within 30 days of the quarter end following the closing date of the financing.[43] This would allow Licensees to submit Form 1031s for all investments made within that quarter at the same time. In response to commenter concerns that submitting a single form simultaneously for all investments could be too burdensome, the final rule allows that Form 1031s may be disaggregated and submitted individually on a more frequent basis if desired.
- **Annual reporting.** SBA requires all Licensees to submit their financial statements and supplementary information annually as part of Form 468. Under the final rule, and consistent with SBA's changes to valuations, Form 468 will 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).[44] In addition, Form 468 currently requires an assessment of the economic impact of each 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. Consistent with the proposed rule, the final rule adds "total jobs created or retained" (including both full-time and part-time jobs) to the categories of information that must be provided, along with a breakdown of the number of jobs added through organic growth and acquisitions.[45] The final rule also provides for disclosure, on a voluntary basis, of certain demographic information with respect to the portfolio concern's ownership, as did the proposed rule.[46] At the fund level, the final rule requires 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.[47]
- **Other reporting items.** SBA regulations currently require that Licensees provide SBA with a copy of any report they also provide to their private investors. Consistent with the proposed rule, the final rule clarifies that such reports must be provided no later than 30 days after the date such report was sent to private investors.[48] Examples given by SBA for the types of reports required to be shared with SBA include any prospectus, quarterly or annual valuation data, materials presented to investors during any meetings (including any annual meeting), fund management demographic information, letter or other publication concerning an SBIC's financial operations or those of any portfolio concern.

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39 §107.503(b)(2).
40 §107.503(d)(1); §107.650.
41 §107.650.
42 §107.1220.
43 §107.640.
44 §107.630(a).
45 §107.630(d).
46 §107.620(b)(2).
47 §107.630(e).
48 §107.660

VI. Revisions to fees and Annual Charge

SBA made significant changes to how it charges (i) Licensing Fees from applicants for SBIC licenses and (ii) the additional Annual Charge that SBICs pay. The final rule does not include previously proposed changes to SBIC examination fees.

Licensing Fees

Previously, SBA charged an Initial Licensing Fee (payable with the submission of the MAQ) and a Final Licensing Fee (payable with the submission of the full application following a green light letter from SBA) both of which were set as a flat fee for all applicants, adjusted annually for inflation in recent years.

Under the final rule, SBA instead will calculate the Initial Licensing Fee based on an SBIC's fund sequence, equal to a fixed fee of between $5,000 and $20,000, whereby a first-fund SBIC will pay a smaller Initial Licensing Fee than a second fund (and so on, until the fourth fund, as shown below).[49]

Thereafter, the Final Licensing Fee will equal the sum of (i) a Final Licensing Base Fee (again increasing based on fund sequence through the fourth fund) plus (ii) 1.25 basis points multiplied by the Leverage dollar amount requested by the applicant.[50]

Fund Sequence	Initial Licensing Fee (USD)	Final Licensing Base Fee (USD)	Final Licensing Incremental Fee (assuming US$175m in leverage)	Total Licensing Fee (assuming US$175m in leverage)
Fund I	$5,000	$10,000	$21,875	$36,875
Fund II	$10,000	$15,000	$21,875	$46,875
Fund III	$15,000	$25,000	$21,875	$61,875
Fund IV+	$20,000	$30,000	$50,000	$71,875

In addition, SBA has also implemented 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

SBA will not implement any of its proposed changes to SBIC examination fees that were included in the proposed rule. Examination fees will continue to be 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.

Annual Charge

Finally, SBA will codify a minimum Annual Charge of 0.40% or 40 basis points, which will be phased in over five years as follows:[51]

- FY 2024: 0.10% or 10 basis points
- FY 2025: 0.20% or 20 basis points
- FY 2026: 0.25% or 25 basis points
- FY 2027: 0.30% or 30 basis points

49 §107.300(c)(1).
50 §107.300(c)(2).
51 §107.1130(d)(1).

- FY 2028: 0.35% or 35 basis points
- FY 2029: 0.40% or 40 basis points

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 0.40% Annual Charge would be the highest Annual Charge that SBA has implemented since FY 2016, SBA argues that the fiscally responsible administration of the SBIC program requires a minimum charge sufficiently robust to address long-term variances in losses and to preserve a zero or negative subsidy cost to the program.

In response to commenter concerns about the costs of the Annual Charge, SBA reduced its proposed Annual Charge from 50 basis points and agreed to phase in the higher Annual Charge on a graduated basis as set forth above.

VII. Use of capital call 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). SBA does not require approval for unsecured third-party debt, although SBA has not defined "secured" or "unsecured."

The proposed rule allowed for Leveraged Licensees to use a secured "Qualified Line of Credit," subject to several conditions and qualifications, without prior SBA approval, thereby formalizing a common SBA practice to approve such loans.[52] The final rule uses the term "Capital Call Line" instead of "Qualified Line of Credit" to better align with industry terminology. Notably, the final rule simplifies some of the conditions proposed for a Leveraged Licensee to obtain a Capital Call Line without prior SBA approval.[53] Those conditions are as follows:[54]

1. the maximum amount of borrowings available must be no more than unfunded Regulatory Capital, as reflected on the most recent Capital Certificate;
2. payment obligations under the Capital Call Line may be secured, but only by unfunded Regulatory Capital;
3. the lender may have a right to debit depository account(s) at the lender's institution, so long as such lender's right to debit is limited to circumstances involving a default of an obligation to pay principal, interest or fees due under the Capital Call Line (and only up to that amount);
4. each borrowing much be repaid, in full, within 120 days after it is drawn;
5. the term of the Capital Call Line may not exceed 12 months, but may be renewable, provided that each new renewal does not exceed 12 months and the SBIC remains in compliance with the conditions of §107.550(c); and
6. the Capital Call Line does not contain any provision permitting the lender to dictate when capital calls are made or otherwise ceding to the lender any control of the Licensee or its operations (though the Capital Call Line may include a provision authorizing the lender to apply certain proceeds to a payment default as described in (3) above).

52 Proposed §107.550(c).
53 §107.550(c).
54 The final rule eliminates conditions in the proposed rule that specified: (1) the line of credit should not exceed 20% of total unfunded binding commitments from Institutional Investors; (2) borrowings should be secured only by unfunded Regulatory Capital, up to 100 percent of the amount plus 90 days of interest; (3) borrowings are for the purpose of maintaining the SBIC's operating liquidity or providing funds for a particular financing or small business; and (4) borrowings 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.

Other than a Capital Call Line that meets the conditions above, SBA approval remains required for secured third-party debt. Under 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. In light of the new approval for Capital Call Lines, the final rule removes this automatic approval feature and permits SBA, as a condition of granting approval, to impose restrictions or limitations as it deems appropriate taking into account a Licensee's historical performance, current financial position, proposed terms of the secured debt and amount of aggregate debt the Licensee will have outstanding (including Leverage).[55] SBA will not favorably consider requests for approval which include a blanket lien on all assets, or security interests in investor commitments in excess of 125% of the proposed borrowing.

VIII. Additional revisions

Finally, the final rule contains several additional important revisions to SBIC regulations, many of which are relevant to Licensees, investors and those who may seek SBIC licenses or seek to make SBIC investments in the future. Some of these are described below.

Definition of "Associate". SBA revised the subsection of the definition of "Associate" relating to the status of an entity Institutional Investor based on its ownership interest in an SBIC. Previously, an entity Institutional Investor whose ownership represents over 33% of the SBIC's Private Capital was an Associate; SBA increased this percentage to 50%.[56] As a change from the prior regulation and the proposed rule, SBA added that for applicable investors over 10% and less than 50% to avoid being "Associates," they can have no role in the management of the SBIC and have no right to control or approve any matter (other than as a result of their vote as a limited partner). It's unclear whether this is also intended to include votes as a member of the limited partner advisory committee (LPAC) of an SBIC.

Generally, the change gives 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.[57] Such a change could result in more concentrated fundraisings by SBICs.

Definition of "Regulatory Capital". SBA revised the definition of Regulatory Capital to clarify what is considered a "questionable commitment" that will be excluded from Regulatory Capital to include commitments that SBA has determined it is unable to enforce under United States law or where there may be an issue of collectability. The final rule also clarifies that Institutional Investors will not be excluded from Regulatory Capital for financial reasons. This change is consistent with recent SBA practice, but adds additional clarity to the regulations.

Definition of "Loan". SBA expanded the definition of a "Loan" to include revenue-based financings or revenue-based loans (which are not defined) if made in exchange for a percentage of the small businesses future revenue, not to exceed 19% of annual gross revenue.[58]

Restrictions on prepayments. SBA revised the regulation prohibiting restrictions on prepayments to clarify that requiring prepayments to be pro rata among a group of lenders is not an improper restriction.[59] This eliminated a prior ambiguity in the regulations.

55 §107.550(d).
56 §107.50, definition of Associate, subsection (2).
57 Instructions to Form 2182, Exhibit G.
58 §107.810.
59 §107.830(c)(2).

Technology and office requirements. In line with technological advances, SBA eliminated 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.[60] As more funds move to remote teams, it is important to note that SBICs are required to maintain an office that is open to the public during normal working hours.[61]

Safe harbor from conflicted investments. SBA prohibits Licensees from engaging in transactions that constitute conflicts of interest, including financing to a Licensee's Associate (which includes any concern in which an affiliated fund owns or controls an equity interest of 10% or more). Previously, SBA provided for a narrow exemption from this rule; SBA is now expanding the safe harbor to cover follow-on investments by the SBIC where an independent third party (i) is investing in the small business at the same time and on the same terms and conditions, (ii) represents a significant portion of the financing, and (iii) the SBIC's prior position is not diminished or diluted to the benefit of an Associate.[62] SBA has not defined what would constitute a "significant portion."

Capital impairment. Previously, SBA required Leveraged Licensees to calculate their capital impairment percentage (CIP) and report to SBA if the SBIC meets a condition of capital impairment. SBA (and not the Licensee) will now calculate the Licensee's CIP each quarter and notify the SBIC if the SBIC is capitally impaired.[63] SBA also amended how it computes a Licensee's CIP to specify that SBA would perform the computations. There would be no substantive change in the CIP formula.[64]

Watchlist. SBA created the concept of a "Watchlist" (replacing the "Enhanced Monitoring" concept in the proposed rule). The Watchlist's purpose is to "help mitigate the potential for a future default or significant regulatory violation."[65] SBA will place an SBIC on the Watchlist for any of the following, which are only modestly changed from the proposed regulation:

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 brought by a federal agency involving felony charges, allegations of dishonesty, fraud, or breach of fiduciary duty;
4. the SBIC has violated a material provision in its LPA or any side letter;
5. bottom quartile performance for the SBIC's primary strategy benchmark and vintage year after three years based on the private investor's TVPI;
6. the SBIC's Leverage Coverage Ratio (LCR) falls below 1.25 [66] or a Capital Impairment Percentage approaching the permitted threshold;
7. the SBIC defaults on its interest payment and fails to pay within 30 days of the date it is due; or
8. outstanding or unresolved regulatory matters (though it's not clear at what point these trigger Watchlist status).

60 §107.504(a).
61 §107.504(b).
62 §107.730(a)(1)(ii).
63 §107.1830.
64 §107.1840; §107.1845.
65 §107.1850.
66 LCR is calculated as (unfunded Regulatory Capital commitments plus net asset value minus outstanding Leverage) / outstanding Leverage.

An SBIC placed on the Watchlist may have to participate in monthly SBA portfolio reviews, file quarterly valuation reports on specific or all portfolio company holdings, and file Form 1031 more often than quarterly.

New exception to 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 to 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 100 or fewer persons. In creating this exception, SBA's intention was to allow SBIC financings into companies owned by private funds. Under the current Company Act rules, however, private funds often rely on Section 3(c)(7) of the Company Act, which exempts entities whose owners are entirely "qualified purchasers." Under the final rule, the size of a small business that is owned by a private fund that is exempt from registration under the Company Act under either Section 3(c)(1) or Section 3(c)(7) is now measured without regard to the size of that private fund and its other portfolio companies.[67] The change provides significant relief and clarity to SBICs in applying the SBA size standards when investing in sponsored transactions.

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.[68] The prior 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 had proposed to allow a non-profit entity that is a Traditional Investment Company to serve as the management company for an SBIC (which must be a for-profit entity). Although it remains unclear how a non-profit entity could satisfy SBA's definition of a Traditional Investment Company, SBA has finalized this provision as proposed. One important caveat is that unlike other Traditional Investment Companies, a non-profit entity may not own more than 70 percent of an SBIC's Regulatory or Leverageable Capital.[69]

Clean-up revisions. Finally, there are several additional revisions 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" and some are very technical (e.g., clarifying that approved reductions in Regulatory Capital will not impact the overline limit for a period of 5 years).

Conclusion

The cumulative effect of the final rule will have a broad and meaningful impact on the SBIC program. Current and future SBIC managers and investors, both those employing Standard Debentures, as well as those who seek to use the new Accrual Debentures, through either Accrual SBICs or Reinvestor SBICs, will all be materially affected.

We will continue to monitor ongoing SBA communications regarding the reforms to the SBIC program, and we will provide updates to clients and friends as we learn more about how SBA reforms work in practice upon taking effect next month.

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67 §121.103(b)(5)(vi).
68 "Leverageable Capital" is equal to Regulatory Capital, excluding unfunded investor commitments as confirmed by the revisions to the §107.50 definition of "Regulatory Capital."
69 §107.150(b)(2).

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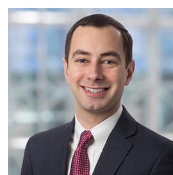

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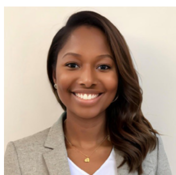

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