

Is the SBIC Program Right for You?

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SMALL BUSINESS INVESTMENT COMPANY PROGRAM

INVESTMENT DIVISION

U. S. SMALL BUSINESS ADMINISTRATION

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WELCOME

The U.S. Small Business Administration welcomes your interest in the Small Business Investment Company (SBIC) program. Since 1959, this program has had a history of successfully assisting small businesses obtain long-term funding for growth. If you are interested in forming an SBIC, we are glad to have your inquiry.

Applicability

This document summarizes the key elements of the process for obtaining an SBIC license. It applies to all parties that intend to seek a license to operate an SBIC, as well as to all existing SBICs that may wish to change ownership or control. If you currently manage an existing SBIC and are seeking another license or wish to convert from one form of SBIC to another, please contact your SBA operations analyst for further guidance.

This document should assist you in determining: (1) whether you and your associates have the experience necessary to participate in the SBIC program, (2) whether the type of investing you are contemplating is compatible with the SBIC program, (3) whether you could operate successfully and comfortably within the SBIC regulatory structure, and (4) how to go about applying for an SBIC license, should you wish to proceed.

The process of obtaining a license is summarized within these six topics:

- I. Understanding the Licensing Standards.
- II. Getting Ready.
- III. The First Steps.
- IV. Preparing the Application.
- V. Filing the Application.
- VI. The Licensing Process.

If you are contemplating applying for an SBIC license, your very first activity should be to read this document from beginning to end. Then, check our web site at www.sba.gov/inv where you can find a wealth of information. Look under the heading *SBIC Licenses*, and check to see that you are reading the latest version of this document. Then, if you have any questions or want to get started on the process, send an email to sbic@sba.gov, and a program development specialist should respond by voice or by email within five working days.

I. UNDERSTANDING THE LICENSING STANDARDS

The Goal of the Licensing Process

As found in *Statement of Policy*, Section 102 of the *Small Business Investment Act of 1958, as amended* (the Act), the purpose of the program is to stimulate the “growth, expansion, and modernization” of small American businesses. In Section 301(c)(3) of the Act, Congress directs the SBA to determine whether “the management of the applicant is qualified and has the knowledge, experience, and capability necessary to comply with [the] Act...” and to assess “the probability of successful operations of the applicant, including adequate profitability and financial soundness.” In addition, the Act sets certain minimum capital requirements which will be discussed below.

The purpose of the licensing process is to ascertain whether all of these elements come together sufficiently in order for there to be a high probability (1) of success for you and your investors, (2) for the SBA to avoid suffering losses, and (3) that management of an SBIC by your team will further the purposes of the program. In the years since the first SBIC was licensed in 1959, we have found that successful SBICs usually have certain characteristics in common. Some of these characteristics can be quantified, but many are intangible. Three broad categories that we look at are:

Experience. The management team of a prospective SBIC should be able to demonstrate that they have experience relevant to successfully managing a venture capital fund. Commercial banking, investment banking, and merger and acquisition experience are relevant, but are not a replacement for experience in venture investing, which involves long-term relationships and value-added beyond finance. Similarly, operating experience in companies can provide an excellent background for managing a venture fund, but the skill set necessary to rely upon reports and meetings with the senior management of a small business is considerably different from being involved in operations on a day-to-day basis.

A Real Team. Your management team should be a group that has previously worked together as a team. If they haven't, then you should be able to demonstrate that you are a cohesive integrated working team, not just a group of individuals who have assembled for the purpose of getting an SBIC license. (One of the identifying characteristics of a real team is whether it shows balance in the skills, experience and influence of its members. Another indicator can be found in the division of the carry among the principals, and whether you are providing incentives to any junior members of your team.)

Ability to Function in a Regulatory Environment. Does your group have the ability to work within the SBA regulations? Our regulatory requirements affect not only the types of investments you can make, but also the way in which you will administer your fund. Successful applicants must be able to demonstrate that they are committed to operating within the framework of the program.

The Business Plan

General Comments. This section refers, for the sake of convenience, to your “business plan”. However, we are actually talking about your answers to a series of structured questions which are designed to enable us to thoroughly analyze your plan of operations. (See the discussion of the “Management Assessment Questionnaire” in section III.)

In reviewing your business plan, we will consider whether your experience is consistent with the type of investing you plan to do, and whether your plan has internal integrity. If all the principals have been doing sub-debt financing of manufacturing companies and now propose to finance early-stage Internet firms, we would find a disconnect, and might be uncomfortable with your plan unless you could point to some other compelling factors.

The plan must be consonant with the amount of capital you anticipate raising, the scope of the geography you intend to cover, your networks, and the type of investing you are contemplating. For example, as a general rule, early stage investing requires considerably more capital to follow investments through multiple rounds of financings. Such investing also demands higher overhead to perform sufficient due diligence and continued close oversight. Based on a management fee no greater than 2.5%, this often implies the need for capital greater than the minimum amounts stipulated in our regulations. Perhaps your plan may not require more than our minimums, but this will be a function of how you plan to go about investing, as well as your relationship with other organizations that may provide support services either to your SBIC or to companies in which you invest.

Does the business plan simultaneously show sufficient focus, but also adequate diversification within the portfolio? Is the projected distribution of investments, both by size and by type, within normal portfolio parameters? As shown in your plan, will your overhead be within the norms of the venture capital industry?

Specific Areas of Focus. In the business plan, there are eight aspects of your proposed operation that we scrutinize:

1. **Deal Flow.** You should be able to show us how you will generate sufficient qualified deal flow; and you must be able to instill confidence in us that your plan to accomplish this is sound and not just fluff.
2. **Focus.** Your investing strategy needs to be focused – not too narrow and not too broad. We will look at your past activities to see what kind of focus

you had, and will make a judgement about whether your SBIC's focus will relate to your experience, to your networks and to the geographies in which you plan to invest.

3. **Deal Processing.** We want to know how the principals plan to interact and process potential investments. You need to be able to explain how you plan to process deals internally, both among the principals and with any junior members of the team.
4. **Selection Process.** What are your screening criteria? How is your decision-making process going to function, and is it a cohesive process?
5. **Due Diligence.** What has your past experience been in performing due diligence, and what is the process going to be in your new SBIC?
6. **Oversight and Value Added.** How will oversight of portfolio companies be handled? To what extent will you be involved in your investments?
7. **Follow-on Decisions.** How will the decision regarding follow-on investments be made? What criteria will be applied? Can you point to prior successful experience in making follow-on judgements? We have found that a salient characteristic of failed SBICs has been the managers' inability to make good follow-on decisions. In other words, they had a tendency to throw good money after bad. What can you point to that will give us comfort in the judgements you have made in the past?
8. **Portfolio Liquidations.** There are mostly five types of exits: (1) sale of a company, (2) IPOs, (3) management buybacks, (4) sale of minority shareholdings to a non-management party, and (5) distress exits. We would like to know about your experience in each of these areas, and for you to convey confidence to us that you know when to sell, as well as when to fold and quit.

Management Qualifications

Now that you're thinking about forming an SBIC, you might ask "What is the SBA looking for, specifically, in management qualifications?" Our experience has been that highly successful SBICs usually have had management teams with:

1. At least one principal who has five or more years of experience with a venture capital fund, doing the same type of private equity investing that the proposed SBIC would perform.
2. A number of successful exits that can show realized gains that would put the aggregate IRR for the exited investments in the upper half of performance for venture funds (of the same category as the applicant) for the year in which the fund was founded.
3. An aggregate IRR on all investments, including both realized and unrealized gains, in the upper half of performance for venture funds (of the same category as the applicant) for the year in which the fund was founded.

This performance record should not be based solely upon one or two successful Internet investments liquidated in the years 1998 through 2000.

If your team lacks some of these accomplishments, does that mean that you cannot hope to receive a license? No, a number of successful SBIC managers did not meet the criteria described above when they received their first licenses. What it means is that the burden is upon you to demonstrate that the experience of the principals is truly relevant and applicable to running an SBIC. As examples, some principals may have done meaningful angel investing, or others may have done venture investing for a corporation.

Whether or not you have previously managed a venture fund, during the licensing process, it is up to you to show how your experience relates to the eight aspects of managing an SBIC as enumerated under The Business Plan section above. It is your task to make us comfortable that your plan is cohesive regarding how you would manage an SBIC, and also that the government would have a low risk of losing money. We are seeking to make our criteria clear so that you do not waste your time or ours, and so that you can ultimately achieve your goals.

II. GETTING READY

Becoming Familiar with the Regulations and Certain Requirements

1. Download Part 107 and Part 121 of the regulations from our web site. Review all of Part 107, plus the definition of a *Small Business* as found in §121.301(c) as well as §121.101 to §121.103 relating to the sizes of qualified Small Businesses. When reading these sections of the regulations, assure yourself that the companies you want to finance will indeed fall within these size and other eligibility standards of the program.
2. **Read the definition of *Associate* carefully** in §107.50 and also read §107.730 regarding conflicts-of-interest. Think through all of your relationships with any affiliates to ensure that there are not likely to be any organizational problems or potential conflicts between your SBIC and any related entities. If you have questions, feel free to discuss these issues with an SBA staff person.
3. We also suggest that you carefully read all of Subpart G of Part 107 that relates to qualifying and structuring investments to be certain that any unique deal structures that you may utilize will not run afoul of our regulations.
4. As you proceed, determine if there will be sufficient independence of management from investors (what SBA regulations refer to as “management and ownership diversity”) to ensure that the SBIC is operated properly and without improper outside pressures? (See §107.150, *Federal Register*, vol. 65, No. 157, Monday, August 14, 2000, page 49511 found at www.gpo.gov.)
5. You should also review the operations forms listed under the hyperlink *SBIC Forms* and get a feel for the reporting requirements in this program.
6. A final issue that prospective applicants who anticipate having foreign investors should consider is the subject of disclosure. While we generally welcome foreign capital because this results in expansion of the U.S. economy and in the creation of U.S. jobs, there are often identification issues that cause concern for foreign investors. Please understand that they (as well as your domestic investors) may have to go through a full disclosure process, including the submission of fingerprint cards, and this may discourage them from investing. They will also have to appoint an agent for service of process in the United States. (If you have any questions on this issue, we strongly advise that you discuss this with us while you are still deciding on whether to go through the licensing process.)

Learning More

You might want to talk with existing SBIC fund managers and learn about their experiences with the SBA. Additional information on the program and the names of trade organizations can be found at *Other Resources* on our web site. You might want to contact some of these resources, and also call lawyers who have processed SBIC license applications to learn what their range of fees is.

Key Questions to Ask Yourself

As a participant in a government program, you will be required to file many timely reports that would not otherwise be required if you were solely a private fund, and your team must be able and willing to comply with SBA regulations governing the SBIC program. You should reach a determination as to whether our regulatory constraints would inhibit your investing style to the extent that you would not be comfortable or successful.

Based on all the material that you will have read, and from conversations that you will have had with us and with others, you should be able to determine (1) whether you believe that you would qualify for a license and (2) whether you wish to continue with this process.

Carefully weigh the tradeoffs. Applying for an SBIC license is not a trivial undertaking as it will probably take over a year from start to finish, and you will incur significant costs in the process.

If you decide to proceed, you should contact the SBA. Just send an email to sbic@sba.gov and an SBA Program Development Analyst will gladly assist you, normally within five business days, depending upon travel schedules.

III. THE FIRST STEPS

Introduction

The application for an SBIC license does not begin with the filing of specific documents. Instead, it starts as an informal process (without any fees) that allows us to probe your qualifications and experience, step-by-step. At each stage, we apprise you of our perceptions so that you can know where you stand as you proceed. Once we have made a determination that you are a good candidate for receiving an SBIC license, we invite you to submit a formal application. The following summarizes this informal process.

Are You Qualified?

After you have established contact with an SBA program development person as directed on page 2, you may be asked to submit a copy of the resumes of the principals. You would then have the benefit of an initial evaluation of the management team's experience. This would not be definitive, but if it appeared that the team's experience or qualifications left a lot to be desired, you could abandon the licensing process before you had invested significant amounts of time and money. Alternatively, you would at least know what the shortfalls of the team might be, and seek to add other persons to the team to compensate for the weaknesses.

MAQ Submission

The next step begins with completing SBA's Management Assessment Questionnaire, or "MAQ" (pronounced "Mac"), consisting of a series of structured questions concerning your plans for the prospective SBIC and the detailed experience and qualifications of your management team. The MAQ consists of two electronic files available through our Program Development staff. When completed, the MAQ should be emailed to sbic@sba.gov. Within three to five business days, you will be notified that it has been received. Normally, your submission will be assigned to a program development specialist within ten business days after you have received confirmation. Within two weeks thereafter, you will be contacted regarding any items that are incomplete or unclear.

The SBA program development specialist will continue to analyze the MAQ in detail, especially with regard to your strengths and weaknesses, and will also be performing some initial due diligence. Generally, within one to two months, this staff person will make a recommendation to the Investment Committee of SBA's Investment Division (composed of senior members of the Division) whether or not to have the principals invited to an interview.

The Interview

The Investment Committee customarily meets every two weeks and discusses MAQs which have been processed. If the initial impression shows that the management team may be qualified for a license, the entire team is invited to our offices in Washington for an interview (which is usually scheduled on a Tuesday, Wednesday, or Thursday). The interview usually lasts about an hour and a half, and we will try to arrange the meeting for your convenience.

Approximately 7 to 15 people from the SBA will be present at the interview and it is conducted in an informal style. Virtually all groups utilize a printed PowerPoint presentation as the structure for the meeting. (If you wish to use a computer projector, let us know in advance and we will have one set up for you. However, if you need to use a laptop computer, you should bring your own.) Unless there is something that particularly lends itself to projection use, our suggestion is that you bring 15 printed copies of your presentation, and work off of the printed versions.

The primary reason for getting together is to enable you to expand on your strengths, as well as to discuss any weak areas of your MAQ. Be prepared to be interrupted with questions continually throughout your presentation. We like to cut through the buzz words and drill down into the eight issues covered under The Business Plan topic in Section I. We will want to learn more about your investing approach, and will be focusing on any ambiguities, weak points, potential structural problems, or potential conflicts of interest that might concern us.

Even though the purpose of the interview is to deal with business issues, not legal issues, many teams do bring their lawyer to the interview. This is not required as we are interested in hearing from the principals, not their attorneys. At the end of the meeting you should feel free to ask us questions, or to express any concerns or reservations that you may have.

The Assessment

At the next meeting of the Investment Committee subsequent to your interview, a determination will be made regarding the perceived ability of the management team to successfully manage an SBIC. There are four possible outcomes of which you could be advised:

1. Your management team appears to be well-qualified and will be invited to file a formal application through the so-called "go forth letter" from us.
2. The management team is generally qualified, but has some weaknesses which we believe can be corrected. You will be advised of our views and asked to make the necessary improvements, and when these have been made to advise us of the changes. At a future Committee meeting, these will be considered, and if they appear to be sufficient, you will then be invited to file an application.

3. The management team is qualified, but there are some structural or conflict-of-interest issues that need to be resolved. As in (2) above, you will be asked to correct them, and when so advised, we will respond.
4. We do not consider the management team to be qualified and/or we question whether the investment approach can be successfully executed. In this instance, we will advise you of this, and ask that you not file another MAQ for at least a year. We will also not be receptive to continuing conversations during this period. (Please bear in mind that this is not an entitlement program.)

You must understand that the Investment Committee only concludes that your team should be invited to submit an application. **This does not mean that the SBA has determined that you are actually qualified to receive an SBIC license.** We will do our best to be as direct and accurate in our assessment as possible, but we will only be working on the basis of an initial evaluation of what you have told us, and some preliminary due diligence. In-depth due diligence will remain to be done, including Statements of Personal History and fingerprint cards filed with the FBI on principals and significant investors. In addition, there will still be many regulatory and legal issues to work through, just as there are in any fund-raising effort in the private sector. The total estimated time for the principals to complete the MAQ is 100 hours, plus an additional 60 hours to complete the Application and balance of the Exhibits.

IV. PREPARING THE APPLICATION

If you have received a “go-forth letter” and if you are prepared to continue, depending upon where you stand in your fundraising process, you may be ready to begin preparing a license application. Your SBA program development specialist will get you started on this process.

Please read the regulatory requirements found in Subpart C of 13 CFR Part 107 — *Qualifying for an SBIC License* — beginning with §107.100. From our web site, you should also download the legal documents, such as the model partnership agreement which we highly recommend that you use as a starting point if you wish your application to move as quickly as possible.

When you start to complete the application, you should be highly confident that you can meet the minimum capital levels specified in §107.200 and §107.210. Commitments of \$10 million of Regulatory Capital (as defined in § 107.50) are necessary if you wish to utilize participating securities leverage, and \$5 million if you are going to use debenture leverage. If you intend to be non-leveraged, you will need commitments of at least \$3 million plus a plan for getting to \$5 million.

In order to file your application, you must have received signed commitments for the appropriate minimum. In addition, if you are seeking leverage, you must also meet the criteria of management and ownership diversity in §107.150.

V. FILING THE APPLICATION

General

You will file the Application along with a check payable to the U.S. Small Business Administration. The filing fee is nonrefundable, and the charges are:

Base Fee	\$10,000
Partnership or LLC SBIC	\$ 5,000 additional
Participating Securities SBIC	\$ 5,000 additional.

Once an Application is received, we will acknowledge receipt by email. Normally, within three weeks, SBA's licensing staff will make a determination of whether to formally accept your application. To be accepted, the application must be complete and you must clearly demonstrate that you have met the minimum capital and management and ownership diversity requirements. We will also advise you regarding the current status of license applications, and when you can expect processing to begin. Once formally accepted, we will immediately forward the fingerprint cards and *Statements of Personal History* to SBA's Office of Inspector General for processing.

Pre-Licensing Investments

As soon as you have been advised in writing that the application is accepted, you may make one **SBA-approved** investment in a Small Business and have it count as both *Regulatory Capital and Leverageable Capital* (as defined in §107.50). This is known as a "Pre-Licensing Investment". **At least 10 days in advance of the closing of the investment, its details must be submitted to us on a form we provide, and it must be approved by us in order for it to be included in your Leverageable and Regulatory Capital.**

If at least one principal of the applicant has attended the all-day Regulations Training Class offered by SBA, an applicant may make more than one investment and have them count towards Regulatory and Leverageable Capital, provided each such investment is pre-approved by the SBA.

Regulations Training Class

Regulations training classes are normally held about 9 times per year in Washington, and twice during the summer, either on the West Coast or in the Midwest. The purpose of this class is to familiarize you, as painlessly as possible, with some of the ins and outs of investing within the SBIC regulatory environment so that you don't inadvertently commit regulatory violations. As an aside, these classes are normally limited in size, and they often fill up two months in advance, so do not leave your reservation for too late in the application process, as a license will not be issued until at least one of the

principals, and preferably all, have attended a class. (Registration for this class is now being handled by the National Association of Small Business Investment Companies [NASBIC] which should be contacted at 202-628-5055.)

You will be expected to arrive at the class before the starting time of 9:00 A.M. and to remain through a working lunch until 5:00 P.M. **Failure to be present for the entire day may result in a requirement that the attendee re-take the class, and it may result in a delay in receiving a license.** For those within a short flying time, we recommend that you **not** try to take an early flight on the day of the class; and for those traveling across multiple time zones, please plan your flights accordingly.

Once you have been licensed, **ALL principals must have attended the regulations class before any leverage will be issued.** Certain non-principals such as significant investors or members of a board of directors are also required to take the class and should plan to attend as soon as practicable. In addition, any employees or consultants whom you have assigned to handle regulatory matters or to interact with the Investment Division should also attend the class.

VI. THE LICENSING PROCESS

General Information

Once the initial processing has been completed by an analyst and an attorney in SBA's Office of General Counsel has reviewed your legal documents, you will be issued a "comment letter". You will be asked to respond by letter, which may be sent to us by mail, fax or email. It is also possible that you may have to travel to our offices for a meeting to discuss significant issues. If there are major deficiencies or issues, it may be necessary to modify and re-file the application.

Our goal will be to resolve any issues, major or minor, as expeditiously as possible through written and oral communications between you and the SBA analyst. Please remember that your promptness in responding is important, and if there are excessive delays in responding, you may lose your place in the queue. Our prompt responses are equally important, and if we are not timely, please let us know.

Processing the Application

From the time we begin substantive processing of the Application, our goal is to complete our review within four to six months. This short time period assumes that you are using the model partnership agreement, and that both you and your attorney provide prompt satisfactory responses to the issues that we raise. Just like the closing of any private financing that you do, the time to completion is ultimately dependent upon ironing out the details, and more complicated structures such as a "drop-down" SBIC (one that is a subsidiary of a venture fund) which may require modifications to your existing agreements can prolong the process. While the legal issues are being worked out, we at the SBA will continue our due diligence activities.

Three Levels of Approval

1. When SBA's licensing staff has completed its review, your license application is presented to the Investment Division Licensing Committee, which generally meets on a monthly basis. This committee is composed of the senior managers of the Division.
2. If your application receives a favorable vote, it is forwarded to the Agency Licensing Committee which is comprised of certain senior managers of the SBA.

Before your application can be presented to the Agency Licensing Committee, you must place at least \$2.5 million on deposit at the SBIC's selected bank and provide SBA with a certification by the bank that the funds are in your account and are unencumbered. (Please note that any approved pre-licensing investments, as well as approved organizational and

operating expenses, can be counted toward this \$2.5 million cash deposit requirement.)

In addition, your Capital Certificate must be signed, and all of your other “legal documents” (including your partnership agreement or other organizational documents, plus legal opinions) must be in “final form” before the Agency Licensing Committee will consider your application. (By “final form”, we mean that everything need not have signatures at this stage, but the documents must be fully agreed upon by both you and us and ready for execution.)

3. If the Agency Licensing Committee votes affirmatively on your license application, as soon as you submit fully executed copies of all legal documents, your application will be forwarded to the SBA Administrator for final action. (Please note that the executed documents must be identical to the “final form” of the documents approved by us.) If the Administrator of the SBA approves your application, your license is issued, and you become a member of our community of SBICs. Because of scheduling difficulties, the formal approval process from Investment Division Licensee Committee to final signature can take from four to six weeks.

The attached Appendix A is provided to assist you in the licensing process. If you have any questions regarding the substance of this document, please contact us. Thank you for your interest.

APPENDIX A

Checklist of Actions Required to Obtain an SBIC License

	Download current version of “Is the SBIC Program Right for You?”
	From time to time, check www.sba.gov for updates
	Download and review 13 CFR Part 107
	Download and review 13 CFR Part 121
	Read definition of <i>Associate</i> very carefully — §107.50
	Read Subpart G of Part 107 on qualifying and structuring investments
	Understand §107.50, definition of <i>Control</i>
	Determine if your investing style comfortably fits within SBA's regulations
	Determine if you think you and your team can qualify for a license
	Talk to SBIC fund managers and to trade associations
	If relevant, discuss foreign investor issues with the SBA
	Complete Management Assessment Questionnaire (MAQ)
	Email Management Assessment Questionnaire to sbic@sba.gov
	Visit SBA for an interview
	Obtain a “Go-Forth Letter”
	Download Model Partnership Agreement or Partnership Annexes
	Ensure that you can meet the minimum capital requirements §§107.200–210 & Subpart C
	Obtain firm commitments from investors to meet minimum capital level
	Complete the <i>SBIC Application</i> with all Exhibits
	File your Application
	Attend the Regulations Training Class
	Make pre-licensing investments (if desired)
	Resolve issues
	Deposit \$2.5 million in bank, if necessary
	Submit signed Capital Certificate plus “final form” legal documents
	Submit executed legal documents
	Obtain License