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SBA REAUTHORIZATION: SMALL BUSINESS VENTURE CAPITAL PROGRAMS

ROUNDTABLE

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

June 21, 2007

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COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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C O N T E N T S

SBA REAUTHORIZATION: SMALL BUSINESS VENTURE CAPITAL PROGRAMS

THURSDAY, JUNE 21, 2007

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
Washington, D.C.

The Committee met, pursuant to notice, at 10:00 a.m., in room SR–428A, Russell Senate Office Building, the Honorable John Kerry, Chairman of the Committee, presiding.

Present: Senator Kerry.

OPENING STATEMENT OF THE HONORABLE JOHN F. KERRY, CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MASSACHUSETTS

Chairman KERRY. Well, good morning everybody.

We'll come to order as if you were not already unbelievably quiet and well-behaved.

I appreciate everybody being here, and I apologize for the small delay, but I am in the middle of negotiations on CAFE standards on the energy bill on the floor, so I am sort of being tugged and yanked in a lot of different directions. We have a vote shortly here, so we are trying to balance the equities.

I really appreciate you being here to discuss the reauthorization of the SBA's venture capital programs, and the general state of access to venture capital money for small businesses. And we appreciate you taking part in a roundtable in this way.

This has proven to be very, very helpful to the Committee, a terrific way to build the record: a better way, frankly, to sort of give all the staffs an opportunity, and the Senators, those who have the time to get here, to dig into these issues with a little less formality than the normal hearing process provides us. And it also allows for a little more give-and-take, which I think is good.

So we want you to feel free to jump in, either by raising your hand or by flipping your name tag up there onto its end like that, and you'll be lined up.

And Kevin Wheeler will run this when I am not here, which will be a large part of it because of what is happening on the floor. That is the way that we have run it previously, and it has really been, by far, the most productive way to get at things here.

Now, I am happy to welcome all of you here, but I am particularly grateful to Ed Tierney, the president of BISCO Environmental and Taunton, and Tom Gorman, the managing director of

Seacoast Capital in Danvers, which are examples of a successful small business that got help through the SBA's SBIC Program and a successful SBIC fund.

We are also fortunate to have with us today an example of a New Markets Venture Capital Fund and a company that it invested in. Ray Moncrief, the executive vice president and chief operating officer of Kentucky Highlands Investment Corporation in London, Kentucky, and Greg Harmeyer, the president of Tier 1 Performance in Covington, Kentucky. And we really appreciate, very, very much, your being here.

It is obviously important—I mean, your experience and your firsthand knowledge of this in sort of seeing how it works, what the impediments are, what the hurdles are, the hoops you have to jump through, where the red tape is that we can get rid of, what we could streamline, what we could simplify, what we could leverage more effectively. I mean, all of these kinds of things would be really helpful to the Committee. So we look forward to hearing that.

And if there are reasons that you think things ought to be tweaked and changed, let us know, because that is the purpose of the reauthorization, to try to make it more effective.

It is interesting that, since the SBIC's inception in 1958, almost 50 years ago, which is rather amazing, SBIC firms have invested some $48 billion in more than 100,000 small businesses. And for fiscal year 2006 alone, 30 percent of all the SBIC investment dollars went to companies that had been in business for 2 years or less. Overall in that year, SBA financing supported 2,000 small businesses and employed a total of 286,000 Americans. That's pretty darn good. And I think it speaks to the job creation start-up capacities, which is exactly what it was targeted for.

Many successful companies have received SBIC financing. Some of them are now household names, as we know: Intel, FedEx, Jenny Craig, Outback Steakhouse. They are all SBIC success stories. And I think, Callaway Golf.

If you looked at the tax revenues and tax base created by the success stories, it probably funds close to the entire SBA budget. It is a pretty darn good return on investment for the Federal tax payer, and people need to know that. People need to have a better sense of what a good return on investment it is.

Companies receiving SBA financing have also consistently appeared on a variety of prominent business lists, including the "Inc. 500", "Business Week's" Hot Growth Companies, and Hot Growth Hall of Fame, "Fortune Magazine's" Best Companies to Work For, and Most Admired Companies, and the FSB 100. And these companies also provide tens of thousands of jobs, and create wealth for a lot of folks who might never have dreamed they would have that kind of wealth. So it is really the American Dream.

Given the important contribution that SBIC funds have made to our economy, Senator Snowe and I worked with a number of you here to draft a bill to reauthorize the program for another 3 years, through 2010, ensuring the availability of this business financing tool.

Beyond mere reauthorization, the legislation simplifies the program's regulations, as I mentioned earlier, to try to attract new investors and allow existing investors to be able to go out and increase their involvement.

We increased the leverage cap for small businesses owned by women and minorities, as well as those located in low-income areas. And finally, we have included a provision which ensures that SBICs licensed under the participating securities program will be able to easily make up follow-on investments in successful companies.

Unlike last year, in our comprehensive SBA Reauthorization Bill, we have not attempted to restructure SBIC participating securities program. As much as this type of straight equity is missing in the market for small firms, as we will hear from Dr. Sohl today—and I would like to see it reinstated, personally—the political reality is that we just cannot, in this environment—with the Office of Management and Budget—we just are not able to get over that hurdle, so to speak, to get OMB to assess any version of an equity program fairly and to give it a reasonable cost. So we are stuck.

So we are going to focus on making the debenture program more user-friendly, restore confidence in the market that the program is here to stay and worth getting into.

Like the SBIC Program, we can speak of important contributions, also, for the New Markets Venture Capital Program. It is still in its infancy, but nevertheless, in many ways, as of March 31, 2006, we have received very encouraging news.

The six new market venture capital companies currently licensed by the SBA invested more than $26 million in 75 financings to more than 39 small businesses in low-income areas across the Nation. These funds leveraged $136 million in additional investments from other sources, and they created or maintained more than 1,600 jobs in areas where people had been suffering from chronic unemployment.

As Dr. Rubin will tell us today, without the SBA's program, this type of investment just would be nonexistent. And we need to build on the good start that we have for that reason. Senator Snowe and I also introduced a bill this week to extend the New Markets Venture Capital Program another 3 years, allowing it to start from 10 to 20 more funds, hopefully.

So we make small but important changes to the program so that it is aligned with the New Markets Tax Credit Program, as Congress intended, and also aligned with its younger, and in some ways, more advanced, sister program at the Department of Agriculture.

These changes should make it easier to attract investors, easier to attract interested fund managers, and that leads to more investments in areas that need it. So hopefully, that will be a positive outcome.

Last, we have included some provisions to diversify the reach of New Markets Venture Capital so that it is available in more areas around the country, and perhaps focus on small manufacturers. These ideas were proposed by my colleague in the House, Congresswoman Moore from Wisconsin, and I'm happy that we are able to include them here.

So we have a lot of voices to hear from. We appreciate your being here. Let me turn now, if I can, to Dr. Sohl and Dr. Sass Rubin to tell us about the state of venture capital for small businesses, the need for developmental venture capital, and then all of you begin the process of weighing and we will build our record.

Thank you.

Dr. SOHL. For those of you who want it, there is a handout, not a PowerPoint.

[The referenced handout follows:]

The State of the Seed Market

Jeffrey E. Sohl

Professor of Entrepreneurship and Decision Science
Director, Center for Venture Research
University of New Hampshire

Washington, DC
June, 2007

Business Angels

- 2006: 234,000 angels, invest $25.6 billion in 51,000 ventures
- 2005: $23.1 billion in 49,500 ventures
- 2004: $22.5 billion in 48,000 ventures
- 2003: $18.1 billion in 42,000 ventures,
- 2002: $15.7 billion in 36,000 ventures,

Center for Venture Research - University of New Hampshire

Venture Capital Funds - US

Year	Total	Deals	per Deal
2000	$106.6 billion	8,221	$13.0 million
2001	$41.3 billion	4,711	$8.8 million
2002	$21.2 billion	3,011	$7.0 million
2003	$18.2 billion	2,715	$6.7 million
2004	$21.6 billion	2,983	$7.2 million
2005	$22.1 billion	3,008	$7.4 million
2006	$25.5 billion	3,416	$7.5 million

National Venture Capital Association

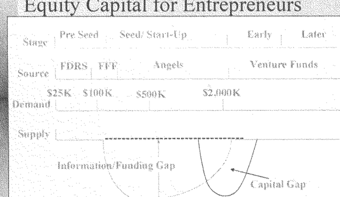
The Truth About Early Stage

Seed and Start-up financing –VC US

2000	$3.2 b (3.0%)	663 deals (8.0%)
2001	$798 m (2.0%)	249 deals (5.1%)
2002	$303 m (1.4%)	148 deals (4.9%)
2003	$354 m (2.0%)	166 deals (6.0%)
2004	$412 m (1.9%)	190 deals (6.3%)
2005	$767 m (3.5%)	184 deals (6.1%)
2006	$1.2 b (4.7%)	312 deals (9.1%)

National Venture Capital Association

Equity Capital for Entrepreneurs



Center for Venture Research - University of New Hampshire

The Gap Dilemma

2006
46% angel : seed and start-up
40% angel : post seed and start –up

	2005	2004	2003	2002
Seed/start-up	55%	43%	52%	50%
post seed/start-up	43%	44%	35%	33%

(25% increase from 2000)

Center for Venture Research - University of New Hampshire

Dr. SOHL. But I wanted to point out a couple things, namely the loss of the seed capital, and I think that dovetails nicely into the New Markets and the SBIC.

And the key people that individuals—or the key source of capital in this whole equity field and seed stage is Business Angels. And if you see from the data, Business Angels last year put in about $26 billion in the U.S. equity markets, and more importantly, funded a little over 50,000 startup companies. Now, some of those are in later stages, but most of them are in startups.

The misnomer with the venture capital industry, they are predominantly later-stage deals. They did a total of about 3,500 deals last year, and their average deal size is about $7 million, whereas the Angel deal size is around $400,000.

And if you break up the venture capital numbers by just seed and startup, the entire venture capital industry did about—well, exactly 312 startup companies last year. Almost all of them are follow-on funding.

So any legislation certainly should, in my opinion, be directed to where the needs are, namely at the seed and startup. And the VC market certainly handles that later stage quite well.

In that little chart that I have there, you can see that there are actually two gaps now, in that roughly under $1 million range, $500,000, or even as low as $50,000 to $1 million is where there are some real private sector with the seed stage. And then, because of another gap in this $1 to $3 million range, that Angels are in fact redistributing some of their capital into that later stage—still very early, but later stage $1 to 3 million, which exacerbates that seed and startup gap. And this is especially acute, certainly under certain markets.

Now, I guess, if the one message I would like on this overview—is that, you know, the seed stage without the seed, obviously we are not going to have any later stage for anybody to play around with.

And the Angel numbers that we see show a slight restructuring and possibly a slight retreating from seed, with about half of their deals now going in a later stage.

So I think any legislation—I would say the two things I would like to see a focus on is certainly at the seed startup stage, as the SBIC, in some cases, does. And also, there is the great potential for co-investing with Angels in both the New Markets and in the SBIC, because now a lot of the new flavor-of-the-month deals are with the Angels is some debt and equity. So in fact, the debentures in the SBICs could in fact possibly be combined with some of the Angel Money.

So I think that is the potential to leverage some existing dollars that are there, and at the same time, get, really, a handle on that acute seed gap in the United States.

Thank you.

Chairman KERRY. Thank you very much, Doctor.

If we could, Dr. Sohl, just reinforce for me the sort of equity importance here.

Dr. SOHL. Well, at this very early stage, it is hard for them to service debt, because they need all the money to stay with the company and to fuel the growth for that company.

And debt servicing is money that is going out the door. So what, ideally, with the equity is—the Angels and the equity dealers at the early stage are in there for a good 5 to 7 years. They don't get out until the entrepreneur and many of the workers get to cash out their equity also.

Chairman KERRY. Isn't that longer now than most venture capital cycles are looking for?

Dr. SOHL. Absolutely. The venture capital industry is a much shorter cycle, and they tend to do a much later stage—deal sizes around $7 million. And they are trying to flip those companies in a good 3 years or 4, because they have the life of a fund of, really 10 years, but only 5 years to invest.

Chairman KERRY. That also is the reason—that underscores, because the equity capital in the mainstream are looking for a faster return, and usually a larger one.

It leaves a lot of these more traditional kinds of business that don't promise that kind of a large return, but also are going to take longer to get that return—it leaves them hanging out there, doesn't it?

Dr. SOHL. You are absolutely right. And that is where the Angels tend to provide, and some other sources—what we call "the patient capital." They are willing to wait, and wait the ride, and then cash out when everybody does so everybody can make a decent return.

But again, they are managing their own money. As a venture capitalist you are a money manager, and somebody has your feet to the fire to get that return pretty quickly.

So you are absolutely right.

Chairman KERRY. I appreciate it.

Kevin, do you want to——

Mr. WHEELER. Dr. Rubin, you want to talk to us about developmental venture capital?

Dr. RUBIN. Thank you. Thank you for inviting me.

My comments are based on my research, which is about a decade of research on venture capital and developmental venture capital, but I am also right now conducting an evaluation of the New Markets Venture Capital Program. So I am speaking specifically to that program, as well.

And I just wanted to follow up with what Professor Sohl said. He talked about the need for seed and early stage money. But as he alluded to, there are two other dramatic needs that the private equity markets are not touching on:

One is for capital in rural and low- and moderate-income areas, and the other is for, as he mentioned, smaller investments, particularly $3 million and less, and even more so, $1 million and less, for a bunch of reasons that we have touched upon, and I'm sure we will discuss more.

The Catch-22 is that, if you wanted to raise a fund to focus on low- and moderate-income in rural areas, you are in a bind to do so, even if you are an experienced venture capitalist, because the sources of capital for venture capital want to see a record of performance. And to have a record of performance in a particular geography, there have to be existing venture funds in that geography. So by definition, you are kind of caught in a bind.

Now, what I am finding is that the New Markets Venture Capital Program has helped address this for the funds that exist in two ways—through the incentives that it offers, through both the grant incentive and the debenture incentive.

And because it provides a grant incentive in particular, it has been able to attract some very high quality venture capitalists who would not otherwise have been interested in doing a program like this, particularly to target low-income areas, because it is so difficult to raise a fund.

The grant has enabled them to offset a lot of the market imperfections that exist in these markets, which is why traditional folks don't want to touch them. And particularly the lack of deal flow, traditional venture capitalists have 300 and up deals a year that they are looking at, and they are selecting one or two to invest in. So they can really cream those deals. They can really take the best of the lot.

If you are working in an area with a distressed location or rural location, by definition, you do not have that kind of deal flow. So what you have to do is provide a lot of technical assistance to the companies that do exist to get them to the point where they are ready to really take advantage of the equity investment and succeed.

And without that grant, it is almost impossible to do that. In particular, a smaller fund, say, under $30 million, just does not have the ability to do any sort of extensive technical assistance out of its base. It needs that grant. And that is what—the role that it has played is to attract folks who would otherwise not be interested in these markets, because they understand it enables them to do that technical assistance.

The debenture is really critical, because it is extraordinarily difficult to raise money, as I mentioned earlier. And actually it has gotten even more difficult, as Ray will probably attest, in the last 5 years for a number of reasons having to do with Bank consolidation, et cetera. And so, just to raise $5 million is very challenging.

Now, what the debenture does is it enables you, obviously, to leverage that $5 million. A $10 million fund is still very small, but at least it is kind of on that threshold of being able to be a viable fund. A $5 million fund is really not viable anymore.

So the grant and the debenture are critical. Now, what I am finding is there a couple areas where the program needs to be tweaked. Overall, it seems to be working quite well, surprisingly well, but I'll just throw these out there, because I am sure we are going to come back to them:

One is targeting. The restrictions that currently exist around investing in census tracts are very, very challenging because census tracts are such a blunt instrument. They change dramatically over the course of 10 years in between censuses, and areas that used to be better off might become poorer, and yet the census track doesn't reflect that. Census tracts are large, so you can have pockets of concentrated poverty that are not reflected in the overall designation of that track.

So it is very challenging to make investments when you have a limited geography if the criteria is one of just location and whether the census track is low-income or not. So some kind of modification on the targeting is really quite necessary. And I heard this very loudly from all the funds.

The other piece that is very challenging is the grant match, because the existing program requires folks to raise a matching grant. You are taking people who are good venture capitalists and asking them to be good at raising grant capital, which are two very different things. And particularly you are asking them to raise grant capital to subsidize a for-profit vehicle. It is just not a very compelling argument when they go out to try to raise that money. So what it has done is it has forced them to spend a lot of valuable time that they could have been raising equity or actually making investments trying to scrounge up this money, and I don't think it is a very good use of resources.

The other issue is that—I would recommend increasing the debenture. And I know that the bill on the table right now has a 1.5-to-1 ratio like the original New Markets legislation. I would argue that is not sufficient.

Because it is so hard to raise money right now, a $10 million fund, which is the smallest that would exist under this legislation, is really almost too small. So I would strongly encourage an increase, at least, to a 2-to-1 leverage ratio, which does not—it is not really 2-to-1, because you have the loss on the debenture discount, but it would at least give the funds a bit more money to actually invest in these regions, and particularly in light of the difficulty of raising capital, in the increasing difficulty of raising capital, for under-served markets, this is a real need.

So I have some additional comments that I will hold for now.

Chairman KERRY. Should we be thinking—when you have this tension in the country, in the body politic, about the ideology: Should the government be doing this or shouldn't it, and so forth?

Would there be a benefit to—in addition to the fund itself, to the SBIC and what we do to target, to creating a better incentive to draw some of that private capital?

I keep hearing how much money is out there looking for deals.

Dr. RUBIN. Right.

Chairman KERRY. But obviously it is not looking for these deals here. It is going to China, to India, to wherever—Greece. You name it. It is very high-flying stuff.

Should we, therefore, be thinking about an incentive outside of the SBIC, i.e., a tax benefit or some kind of a deal that draws that capital, or write that into the SBIC?

Dr. RUBIN. Well, I think when the New Markets tax credit was being put together there was an expectation that it would provide an incentive for equity capital in distressed areas. Unfortunately, because of the way some of the regulations have work, that has not panned out.

I think a tax credit or a vehicle like that would be tremendously helpful. It really is a crying need——

Chairman KERRY [continuing]. Low-income housing credit, which has been a critical component of the syndication of housing to the billions of dollars. And we have had huge benefits as a consequence. If you did that, also, perhaps, on this side of things, it could be conceivably very exciting.

Dr. RUBIN. Yes.

Mr. WHEELER. Ray, do you want to make a comment?

Mr. MONCRIEF. I do.

A couple of comments that Dr. Rubin made, specifically in the area of deal size. Quite frankly, there is a lot of money out there in America looking for deals. The problem that we have in the New Markets Venture Capital arena is that there are deals out there with quality entrepreneurs, such as one sitting next to me that runs a very successful company, except that the deal size that he needs to finance his company—he does not need $5 million in venture capital.

Typically, he does not need $5 million in venture capital on low valuation, where he ended up being the vast minority shareholder in his company. So consequently, the New Markets Venture Capital Program provides, in socially and economically disadvantaged areas, of whether he is in downtown HUBZone Covington, Kentucky—he was looking for a small round, a $750,000 Series A round.

Most traditional VC does not do that because of transaction costs. We do that in the New Markets Venture Capital for all the reasons that Dr. Rubin talked about.

So there needs to be an incentive, No. 1, for more of these New Markets Venture Capital funds to exist. The biggest drain is not the ability to raise the money. The biggest drain is not the ability to invest it. It is having the capacity or the practitioners that are willing to work in low-income areas as opposed to traditional areas, which is the most significant issue that we face.

And I do echo all that Dr. Rubin said. I would ditto everything she said as far as the way that the bill needs to be tweaked, or the industry needs to be tweaked.

Chairman KERRY. That's interesting. You're saying that it is difficult to find the employees who are willing to come into whatever that geographic location is?

Mr. MONCRIEF. No, sir. I don't think it is difficult at all to get the employees.

For example, we have an investment——

Chairman KERRY. Well, what did you say?

I'm sorry. I misinterpreted what you said, then.

Mr. MONCRIEF. I am talking about the capacity of the practitioners to invest in these areas, not the employees to work in the companies.

Dr. RUBIN. Venture capitalists.

Mr. MONCRIEF. Most of the venture capital practitioners.

You know, you have to ask the question: Why would a venture capital practitioner that has the ability to run a $150 or $300 million fund want to move into a low-income census track and do deals from $500,000 to $1 million?

Well, there has to be something else besides a cash on cash return that motivates people to do that. And consequently, there need to be incentives for people to move into that arena from traditional funds.

Chairman KERRY. What do you think those appreciation incentives are?

Mr. MONCRIEF. That's a good question.

No. 1, there have to be old guys like myself that are in the careers that have made enough money and that are willing to spend their time investing this type of money in low-income census tracts. That is No. 1. And there needs to be a reason for that, such as the operational assistance component.

I agree that the leverage needs to be more than one and-a-half, it needs to be at least two to kind of marry it up with what we are doing under the RBIC Program.

Those sorts of things that would give us the cash to do reasonable deals in low-income census tracts would be a great attractor.

Chairman KERRY. Interesting.

Any other economic incentives?

Mr. MONCRIEF. Well, there can always be a tax consequence——

[Laughter.]

Mr. MONCRIEF [continuing]. On capital gains and things of that nature that would incentivize—much akin to what happened in the legislation with the Empowerment Zones.

Investments in Empowerment Zones, as you might recall, there are no tax consequences to gains on companies that are sold in Empowerment Zones. And consequently that, in a rural market that I work in, has been profoundly successful of investments in companies—to forming in those rural census tracts.

Chairman KERRY. We could always give you a discount on the ARP Guard or something, right?

Mr. MONCRIEF. That would work.

Chairman KERRY. I have to run in a moment, because I just got my language on this CAFE thing, but why don't you keep running here.

Mr. WHEELER. OK. As Senator Kerry said, our purpose here is to build a record to justify the need for SBA's VC programs, both the New Markets Venture Capital and the SBIC.

We want to discuss—we have already been through the general state of VC and that of developmental capital. We also want to touch upon the need of VC for businesses owned by women and minorities.

Now that we have heard from Dr. Sohl and Dr. Rubin, let's go ahead and open it up to the Small Business Investment Company Program.

We'll let Lee Mercer begin—do you want to just give us a brief overview of the SBIC program?

Mr. MERCER. I am going to let Steve go ahead.

Mr. WHEELER. Let Steve go ahead?

Just give us a brief overview of the program, and then we will open it up to talk about proposals that are out there that you are asking for.

Mr. VIVIAN. Thanks. And thank you, Chairman Kerry, for inviting us and for your long support of the SBIC Program, and all that you have done over the years for it.

I am just going to spend a couple of minutes on the overview of the SBIC Program. Before I start, we have done everything from early-stage investing to late-stage investing. We run two SBICs in Chicago. And there is a discussion period later. And since I do not know what is going to happen in the discussion period, our attorneys have advised that I am supposed to say that I would not like to see this on YouTube. I do not give video permission distribution to YouTube.

The SBIC Program really has three legs of a stool. A lot of people think it only has one program; there are actually three programs. The program that started in 1958 is the debenture program, which is still very strong today.

That program allows 2-to-1 leverage against private capital that general partners like myself and my five partners will go out and raise to invest debt, primarily, into small businesses. And there are currently 135 debenture SBICs managing just under $6 billion of capital. And they invested $1.2 billion in fiscal year 2006 into small businesses.

The second component of the SBIC Program consists of unleveraged bank-owned SBICs, which was really much more popular back in the late 1950s and early 1960s. However, in 1999, the passage of Graham-Leach-Bliley allowed bank holding companies to have their own subsidiaries that could do venture capital and private equity investing. And so today there are only 58 bank-owned licenses left on the books, and they invested about $188 million in 2006.

The third leg of the stool, which Senator Kerry has mentioned, is the participating securities program. I am from Prism in Chicago. We have one of each license: both the participating securities license and the debenture license. That program is really in wind-down phase. It was started in 1994. It ended, really, from a new license standpoint, in 2004 when the SBA stopped licensing, due to a couple of reasons: losses and the determination, as Senator Kerry mentioned, that the program no longer qualified for the Federal Credit Reform Act.

However, the leverage that is available expires in 2008. And so we are pleased to see that there is some effort to allow PS funds to draw new leverage. There are currently 167 remaining PS licensees, and they manage about $11.6 billion in capital. They invested about $1.5 billion in 2006.

Lee is going to talk a little bit about the proposals in the bill, but I just thought maybe it would be interesting to hear from Ed Tierney, who is an SBIC-backed company, to have him comment on what it was like to raise capital, and what it has been like, and why he took SBIC money.

Mr. TIERNEY. Sure. Thank you, Steve, and thank you, Chairman Kerry.

Our company, BISCO Environmental, was founded in 1990, and we had reached a critical mass of a growth period in the year 2005. I say a critical mass, where our growth had stressed our infrastructure, our ability to raise capital, during a period within the industry where opportunities were abound, because our industry had matured as a relatively new industry. This environmental cleanup industry really got its start in the late 1980s and early 1990s. So there were a lot of competing companies looking to reach their goals and come out on top, while others were struggling.

At that critical point, we looked for avenues of capital to continue to support our growth. And through an extended search, we went into a relationship with Seacoast Capital, an SBIC company.

My background, of course, is engineering and running a business. This is relatively new to me, but this has been an enlightening experience. They have been an exceptional firm to work with. We have realized a substantial improvement in our infrastructure—we have hired staff. We have been able to obtain a new facility. We have brought additional jobs into our local area. We have made an acquisition and are looking at a couple other acquisitions right now that I believe will allow us to truly come out on top in an industry which is really looking for a leader and lacking a leadership right now as it goes through a change or a flux period, as the market matures, and the industry matures, and the competition stiffens, and the margins become a little tighter, it is—this relationship has helped us in that area with the infusion of cash to help us realize our goals.

One other side note beyond the money has just been sort of the mentoring aspect of this, I'll call it, where Seacoast Capital has allowed us access, through their network of contacts, to work with professionals and get some professional insight into methods of management, methods of operation and finance that a company of our size may not have had access to previously.

Mr. VIVIAN. And he's not saying that because his board member is sitting beside him, either.

[Laughter.]

Mr. TIERNEY. Well, he may be.

Chairman KERRY. Thank you all again. I appreciate it, thanks.

Mr. MERCER. Well, NASBIC has made three proposals.

And the proposals that we have made are in keeping with the goal that we have set for ourselves—that the Board of Governors set for itself at the beginning of the year, which was really to improve the reputation of the SBIC Program, which had been damaged by the participating security situation, and to find areas where we could simplify and rationalize either laws or regulations we have developed, over the past year. Because of this, I think our relationship with the SBA has become much, much better than it had been in the past. And we have worked successfully with the SBA to identify several areas where changes could be made in the regulations that will meet the goal that we have set for ourselves, which is to, again, improve their reputation, to simplify, to eliminate unnecessary work.

There are three areas where we believed it was necessary to change the law. And the first one that I want to focus on goes by the arcane name of aggregate limitations, or overlying limit. And what it really means is: How much can a single SBIC invest in a portfolio company? What percentage of its investment capital can an SBIC invest in a portfolio company without seeking an exception from SBA?

The purpose of putting in limits like that, and the limit in the current law is no more than 20 percent of private capital, is to make sure that SBICs have diversified portfolios to mitigate risk where possible. Obviously, you don't want people having the ability to go to Atlantic City and let it all ride on 00 in one investment.

So it is a reasonable thing to have in the law. And in fact, in non-SBIC private equity funds, there are also limits found in those agreements to protect investors or to make sure that investors are satisfied that there will be a diversified fund.

In the private market, the limit that is—today's limit is no more than 20 percent or 25 percent in some funds, if they are really later stage funds—no more than 20 to 25 percent of total capital invested in any one portfolio company.

The SBIC law is far under-market. Twenty percent of private capital is the rule. And what that means is that, in a company that is leveraged 1-to-1, in other words, draws a matching tier of leverage to match its private capital, it equates to more than 10 percent of total capital in any one portfolio company.

A company that is leveraged 1.5-to-1, which is probably the average in the—remember that, in the SBIC Program, the law contemplates as much as 3-to-1 leverage, but the average, and SBA can speak to this, is probably around 1.5- to-1, the effective average. Under that, no more than 8 percent can be invested in any one portfolio company. And if you are lucky enough to get to 2-to-1 leverage, it is no more than 6.7 percent.

So if our goal is to make the debenture program attractive to a greater number of investment professionals and their investors, the current law is just too far under market. It stresses management teams.

I know that some people might say, well, if we keep the law the way it is it will force them to invest in more and more companies that are smaller and smaller. It is just not the truth. What it will do is force them—because they can only stretch their management time so far, it just will end up that companies will not take as much leverage, will not grow as much as they normally might be able to under the program. And therefore, the total dollars flowing into the small business community will actually be reduced.

And we have addressed the smaller enterprises in another proposal by suggesting that the limit be increased from 20 percent to 25 percent. So we are hopeful that both SBA and the Committee will look at the current market and—what we have proposed is not even taking it up to current market level in terms of amount of money that can be invested in one portfolio company, but at least would be—the compromise that we have proposed is an increase of 25 percent from the current limit.

Mr. WHEELER. But of only private capital or total fund?

Mr. MERCER. Well, the most recent language that I shared with you and SBA would be, let's keep it simple and keep the law the same, and just say that 20 percent of private capital is raised up to 25 percent of private capital. And then you can do—you know, so, in a 1-to-1 leveraged fund, instead of 10 percent it would be 12.5 percent of private capital. In a 1.5-to-1, it would be about 10 percent of private capital. It would still be below market, but at least it would be an indication to the SBIC community and those who might consider it, that there is at least some recognition that the market has passed by the SBIC law at this time.

Mr. WHEELER. SBA, do you want to comment on that, because we would like to work with you to find a compromise on this?

As Lee said, it is not in the current legislation that was introduced this week, but if you have any comments——

Mr. HAGER. We are looking at what Lee shared directly with us, which is the package sent to you, plus the two proposals that we received last evening—late yesterday afternoon.

And I think we certainly have lots to evaluate. We are working on the package that Lee gave us actively. It is still a little early for us to say we are going to recommend the following. But Lee does bring to the table lots of merit, but again, we just have to sit back and evaluate—of course, do our budgeting, to see what kind of impact it might have to our modeling, and then come back with some compromises.

I would like to, if I may—could I make just a couple of comments just to lead into that?

Mr. WHEELER. Sure.

Mr. HAGER. You know, it has been challenging the last few years, particularly driven by the participating program. As we all know, out of $8.5 billion, we are looking at losses, currently, at about $2.5 billion.

We have another roughly $2 billion yet to go that we are committed, and we are going to honor those commitments. And that will likely yield another $300 to 700 million in losses, bringing that loss number to about $3 billion.

We have spent a lot of time working on what we can do to stabilize that product, that environment. And I am pleased to say that, with a lot of solid management steps, that the current portfolio has stabilized. While some additional losses, as I say, are likely to occur, we have seen the overall program stabilized.

Bond holders received distribution of almost, between the SBA and the bond holders, $1.5 billion.

The debenture program is, we think, doing very well. Solid performance. In 2006, the guaranteed amount over $400 billion. We, again, see 20 percent of the venture going to the LMI areas. We are real pleased about that.

Additionally, our efforts to serve the under-served markets continues to foster lots of economic developments in LI areas. The New Markets Venture Capital program is based on, as you know, the SBIC Program. It is unique, and the fund managers in the New Markets Venture Capital area received grant funding to provide operational assistance.

Again, we are real pleased with what has happened to date. You have already heard Senator Kerry make reference to it: $40 million in equity investments over 50 portfolios, creating 400 new jobs in addition to about 1,100 we have sustained.

It will also provide over $10 million in no-cost operational assistance to over 170—I am reading this, as you can see, the numbers—170 actual potential portfolio companies. Again, we are very pleased with what is happening there.

It is still early. We want to see the program mature, and see where we go from here with that program, but we are encouraged at this point. Thank you.

Mr. WHEELER. Thank you.

Mike, may I just ask you to submit your statement—we are really just trying to get to a markup on Tuesday, and so we would like to go through the proposals. And just quickly, on what Lee said, that from NASBIC—get SBA's feedback—their proposals.

Even if SBA is not prepared to take a stand on aggregate limitations, could you at least tell us what would be your concerns about it, because we would like to decide whether we are going to go to markup with it or not?

Mr. ROWE. I think a lot of what you are getting at here is very welcome to us.

Let's face it, over the years, folks have recognized both in the industry and at SBA that there are areas that are just unduly complicated, whether it is some of the overlying structure or some of the other investment limitations that make it difficult for fund managers to spend the time looking at the merits of the investments, rather than wondering, well, what's my percentage in the smaller enterprises today?

That being said, as well, while our maximum leverage levels are set based on the CPI, you obviously would have to note that the average deal size is not linked that way. And what Lee talked about, where we would go from, say, 10 percent of private capital to 12.5, obviously, that means that the average deal is going to increase slightly.

But when you look at when that law was written going forward to today—I mean, 2 percent is not an outrageous increase if you thought about it in terms of average deal size as a result.

I think Harry can speak a lot better to the mechanics of what we deal with at the Agency.

Mr. MERCER. Can I just——

Mr. WHEELER. Sure.

Mr. MERCER. I just want to break in and just reiterate that it does not mean that every deal is going to get the maximum amount of capital, because deals are done in stages: There is an initial investment, and then an amount of money is reserved for follow-on investments. And some of those early deals, some of the original deals will not merit further support, or will need further support.

But the ones, the few, that do, that is where the maximum comes in. And I even understand—Seacoast can speak to this. I think they are up against the limit right now with Ed Tierney, and they will not be able to fund his need for more capital.

Mr. WHEELER. Because you would pass over the 20 percent investment in one company of your entire fund?

Mr. DEBOW. Right.

There are some very attractive investment opportunities that we have, that BISCO has, as opportunities to grow the company, and if we are going to go forward with that, we are either going to have to find a co-investor or someone else to support it.

And frankly, from an investment standpoint, you know, we have spent the time and effort to kind of get the company to where it is today, and to essentially hand that opportunity off to someone else does not make a lot of sense, from an investment standpoint.

Mr. WHEELER. So would you not make the deal? Is that the risk, that you would not put the extra money in?

Mr. DEBOW. Right. The risk is that we would basically choose not to—first of all, we can't support the company, because we would go over the limit, and either the company—we either find capital from somebody else to support it or the investment does not happen.

Mr. MERCER. Well, they can apply to the SBA for an exception. And I know exceptions—Harry will tell us that exceptions are granted.

But I have to tell you, and I want to be brutally honest about this, and we have said it at the SBA before, that SBA is not known for timely attention to requests for exceptions, and you cannot be certain that they will be granted at all times.

So our proposal to increase it to something that is still less than market, with, still, the ability to go back for an exception, would eliminate, in my view, a whole bunch of requests for exceptions that are probably granted, or would be granted, and leave the exception process for something that is truly either at market or far above market.

Sorry, Harry.

Mr. MONCRIEF. I'd like to—excuse me. I would like to piggyback on Lee.

I think Lee's comment is extraordinarily pertinent to this situation, especially for the smaller New Markets Venture Capital fund, because 20 percent of private equity for a fund my size is a whole lot different than other SBICs.

And the real impact that it has on a New Markets Venture Capital Fund is that, if the company really heats up and does extraordinarily well and needs a Series B round, a Series C round, I have to throttle back what I can invest just like Tom is throttling back in limiting what he can do in the company. Or if he goes ahead and puts his balance all the way up to the 20 percent, then on a subsequent round he is going to be diluted. And he will end up getting less of a takeaway in an ultimate liquidation process.

So it is very important, and I think a 5 percent increase of the regulatory capital is extraordinarily modest. As a matter of fact, I say it is overly modest, quite frankly. I not only think that it is necessary, I think it demands to be discussed.

Mr. WHEELER. Harry, would you like to make a comment?

Mr. HASKINS. I think we support efforts to simplify the program and make it more attractive and reduce the administrative burden.

A concern that we have, and I am not saying that it is a concern that would lead us to oppose a provision, is that the 25 not now act as a base, and that we now get the same number of exception requests starting from 25 as opposed to 20. We don't want to just change the threshold level to which people come in, to the extent that it actually does limit the amount of exception requests I think is one we would definitely consider. We would like to look at what our experience has been in terms of overlying approvals that have been granted.

But we definitely share the goal of NASBIC in trying to reduce the administrative burden and make the program more attractive.

Mr. VIVIAN. I think, Kevin, if the goal is to make the debenture program more attractive to GPs that run funds, it is well below market.

I mean, it is well below market. So if your desire is to attract talented GPs to the program that want to invest capital in these small businesses, which Tom, and I, and do, it is a real—it is a challenge. I think every manager sitting here will tell you they have faced that challenge.

And to play on your point, you know, in Ed's case, Tom can go to Ed and say, you are not going to make the acquisition. So he can stultify the growth of a small business because he is capped and he does not want to get diluted and does not want to have somebody else come in and put onerous terms in on the investment, and that happens all the time, unfortunately.

Mr. DEBOW. I guess the additional point I would like to make is a slightly different point, which is: OK, we have a pool of capital to invest, and if you look at the mechanics of it—OK, we have roughly $30 million of private capital. So we can invest up to $6 million in any single deal.

Like many debenture deals, we are levered 2-to-1. So it is essentially a $90 million, but in order to invest—OK. So if $6 million is our cap, we certainly do not really want to go above four or five at the most at the initial investment, which is still well below the average kind of venture capital investment you said of $7 million.

And the issue becomes, how many deals, frankly, can we manage? If you have to invest $4 million a slug, that means, for us, something, anywhere from 25 plus deals to manage and invest and to work your way through.

And it is very difficult, frankly, for me to manage that number. We have four partners in our firm. And so, when you start doing the math, that means five or six deals per partner, which is, frankly, hard to give the company the amount of attention that it needs.

And very often, frankly, Ed will call me and it is 2 days before I get back to him, because I am traveling or something on two other things. Now, that 2 days usually is not critical, but it is the overall—the more attention that we can give to certain portfolio companies, the stronger they are going to become, because that is really—I don't know if Ed would agree with this, almost more than our capital, it is the advice that we bring to get the company from stage A to stage B is equally, if not more, important than the capital.

Mr. WHEELER. So the cap is inadvertently watering down the fund a little bit.

Mr. DEBOW. Yes.

Mr. WHEELER. Greg—sorry, Greg wanted to make a comment.

Go ahead, Matthew.

Mr. BERGER. Is there any risk to the proposal in the sense that you could have good money chasing a bad investment if you increase the cap?

Mr. HASKINS. That is a concern of the overlying investments, is that you would have that situation, and we have not analyzed what our experience has been to indicate whether that has been a result—an inordinate amount of times.

We would like to perform that analysis before we take a position on the specific proposal.

Mr. DEBOW. Anecdotally—I'm sorry. We had—we are now investing our second fund.

In our first fund, we had two overlyings approved. And in each case, frankly, they worked out very well for the investor and for the SBA.

Mr. HARMEYER. I was just going to make a comment from the company's perspective and kind of echo some of what you are saying.

When you are looking at investors, it is an enormous effort to manage an investor, to find an investor, and to find a relationship that works. I mean, it is a marriage.

And if you are limited by follow-on investment to say, you are going to have to find somebody else, that is a big drain on the company's resources to be able to manage multiple investors who may have different interests, who have different, competing thoughts of where they want to go with the company. And so I think that is a detriment to the company if the investor is limited.

I also would completely agree that the more an investment company is diluted and has too many companies, the less attention they are going to give you in helping you grow your business. So that is another thing that companies are going to look at. And I think it is worth considering from that perspective.

Mr. WHEELER. That is a good point, a very good point. Thank you.

Mr. HASKINS. I would just like to follow up on that.

This is an issue that provides a heavy administrative burden on the Agency, and it is one where we would like to find a way to reduce that burden. So we are very interested in working with the industry to address the issue.

So we haven't taken a specific position, but we do want to try and resolve this issue favorably to all of this.

Mr. VIVIAN. We'll say 40, you say 30, and we can be done.

[Laughter.]

Mr. MERCER. Deal or no deal.

Mr. WHEELER. Let's let Dr. Sohl make a comment. He wanted to weigh in here.

Dr. SOHL. There is one comment—and I understand the need for the dry powder and do less structured round, and I understand all that.

But I get this undercurrent that dilution—we don't want any dilution, and I think that is unrealistic. I mean, I think we all know that.

If you are an equity investor, there will be dilution. Not all dilution is bad, just as long as the valuation goes up. The cram-downs are what kills you. So if you make a good deal and values go up, there is nothing wrong with dilution. Again, it is the cram-downs.

So it just seems like we are trying to tweak this to—and I am not going to make a lot of friends right now, but tweak it to invest in and play in a crowded field. And I agree with you, you need some dry powder, but I don't want to go crazy. I do not think it would be, for the market and, really, the entrepreneurs, to say that I am going to have one marriage to one person for the entire life of this deal. You actually have three or four wives as you go through different stages, just like you have three or four entrepreneurs because the management team, often, is not there at the exit.

So I think we are competing with a very later stage. It is just making me nervous. I just would rather see it a little bit earlier.

And yes, dilution is not a bad thing. Have some for dry powder, but do not expect to take the deal without dilution.

Mr. WHEELER. One last question——

Mr. MERCER. Remember, we are talking about debenture program.

Dr. SOHL. Right.

Mr. MERCER. This is a debt program. It is a later stage focused program.

Dr. SOHL. Oh, I know.

Mr. MERCER. We are not talking about early stage active investments.

Dr. SOHL. But there has to be equity in the company somewhere, right?

Mr. MERCER. The equity slice may come at some times from the SBIC, but in all likelihood, the equity slice is coming from another investor.

Dr. SOHL. Right, but still—well, dilution is——

Mr. MERCER. That investor is not going to be an SBIC, because the participating security program, the equity program, is going out of business.

Dr. SOHL. We know that. We know that. We heard that at the beginning.

Mr. WHEELER. May I just ask one more question of the SBA.

In general, how many of these requests to go over are granted? Is it in the majority of the cases?

Mr. HASKINS. I believe it is the majority, yes.

Mr. WHEELER. OK. Well, thank you.

Lee, did you want to go over the other two proposals that you had?

Mr. MERCER. There are two other proposals.

The first takes a look at the hodge-podge of laws that grew up about the maximum amount of leverage that could be drawn by any one SBIC or group of co-managed SBICs. And it also involves what percentage of funds capital has to be invested in, smaller enterprises, which are a subset of qualifying small businesses.

And it also talks to the part of the statute that increases the maximum leverage each year by reference to an increase in the Consumer Price Index.

And so our feeling that this was an area where, (a), it could be simplified, and (b), could give Congress back the control that it probably should have with regard to increases in maximum leverage limits, particularly if we are going to be heading into an era of much higher increases in the CPI.

And (b), could provide a ramp, if you will, for second funds, and more and more of the debenture funds are second funds, so that if an original fund draws the maximum leverage and gets a second license, it may be restricted in its use of leverage until the first fund pays down a significant portion of its original leverage.

And so for all those reasons, we made the proposal. We also thought that, because of SBA's interest and the Committee's interest in seeing the SBIC program perhaps do more for investing in women- and minority-owned companies that, if nothing else, perhaps an incentive of more money being available would do the trick. So that is in the proposal as well, and I think it is well set out in the draft legislation.

The third proposal is our last attempt to try to help the existing participating security SBICs that are in good operating condition—these are not companies that are in capital impairment or in liquidation. They are operating well. The have leverage commitments that run through September 30, 2008. They are drawing against—the only way they can draw against those commitments is if they need money within—that they can show SBA that they need money some time in the next 90 days before they draw it.

And what is going to happen is, at the normal investment rates, many of these funds will get to the September 30, 2008 date and will lose the remaining capital that would otherwise have been available to them, because, by its terms, the commitment will expire.

So as this last attempt we decided, let's try to figure out a way where we do not have any new leverage. There is no new leverage involved. And we just try to find a way that would be protective, hopefully, of SBA's interest, but still allow these SBICs to draw a greater percentage of the leverage from their existing commitments than would otherwise be the case under current law.

And under current law, in order to draw leverage, a company must draw in at least one part of private capital against private commitments, and those commitments do not expire until the end of the funds life. And once that capital is drawn in, they can draw two parts of leverage, and end up with three parts for investing.

So our proposal is that, just for those participating security funds that hold these valid participating security commitments, that, instead of requiring them to—if they need $3.00, instead of requiring them to draw one of their remaining private dollars into publicly guaranteed dollars, you allow them to draw the $3.00 still supported by private commitments. And those private commitments have been validated by SBA. If they become unsure of them, they can take action against the SBIC.

And if the SBIC gets into financial difficulty, the SBA has the right, under the law and the regulations, to call all those private commitments and pay them directly to SBA. Do not pass go.

So this was our attempt to just use more of the money that the SBICs have already paid a commitment fee for, and reserve the private capital that remains to support the portfolio after the September 30, 2008 date. And many of these SBICs had anticipated being in business through 2014. So that is the proposal.

Mr. WHEELER. Would SBA like to comment on the last one?

Mr. MERCER. Deal.

[Laughter.]

Mr. ROWE. That one, actually, because we are changing the legislation and actually going in and looking at the terms of drawing the leverage, we are just not sure at this point whether it might have a budget implication. Then again, it may have a technical budget implication and then be budget neutral, in which case it does not matter.

But we just don't know, because we are trying to figure out—we are understanding this as essentially being a timing issue, where the funds will draw the leverage on the commitments, but the regulatory capital, rather than becoming paid in, simply just stays regulatory.

So it is still there, it is just not invested in the same ratio relationship with the leverage that is drawn down, the way it currently works. It is just, at this point, from a purely budgetary standpoint, we are not sure whether this has any effect at all. So we have to reserve judgment on that.

We understand completely what the point of view is, and all along the SBA's position is, we will always honor the commitment. I mean, we know that people have paid commitment fees, and we know we have an obligation there. What this is, is a change that—I give Lee credit. It is a great idea, it has just caught us with a, gee, I do not know how that works.

Mr. MERCER. Deal.

Mr. WHEELER. But you are saying that you will just go ahead and let them do it, but you do not want us to change the law?

Mr. ROWE. Well, no.

What I am saying is, we don't know what that change in the law and the change in the way the leverage is drawn down without the regulatory capital becoming paid in, how that had an budgetary effect, if any. We are just trying to figure that out right now. It is kind of a new idea.

Mr. WHEELER. But isn't there a risk that if we do not do anything to help these funds, that we could cause them to fail and there would be an even bigger budgetary cost? Should there be any budgetary cost to this legislative change?

Mr. ROWE. Yes. It is not a question of—obviously there is a potential to be penny wise and pound foolish.

And again, as I said, we are never in a position of denying someone's wanting to draw the leverage for which they have paid a commitment fee. That is not the issue.

The whole issue is, if we make this change in the legislation, does that act as a modification in the budget rules? And if it is a modification, is it a modification that is budget neutral, or does it have an effect, positive or negative?

And that is just what we haven't had a chance to figure out yet.

Mr. WHEELER. What is the cost if we don't do this?

Mr. ROWE. I don't know if that is——

Mr. WHEELER. For instance, these firms will never be able to draw on that money.

Mr. ROWE. No. I don't think the situation is that they would never be able to draw on the money. I think the situation is this lets them draw the money earlier perhaps and reserve their private capital for follow-on investment at later dates.

The question is, and it is purely hypothetical and prospective is we are looking forward to say—and Harry, correct if I am wrong—I think the last of these commitments expire in 2008 some time?

Mr. HASKINS. Yes. September 30, 2008.

Mr. ROWE. Yes. So the question is, what investments need to be made after that? And I don't think we are in a position to make that estimate.

Now, obviously, the funds have been obligated. The commitment fees have been paid. What we are just trying to figure out is, if this goes forward, what if any budgetary effect can we foresee this having? And again, it is the same question. We can't foresee what need they do or do not have.

Mr. WHEELER. But SBA is not concerned about a financial risk of allowing them to change it from paid in to just their commitments?

This is not a risk question. This is a budgetary issue.

Mr. ROWE. I'm not sure it is a risk question.

Mr. WHEELER. Harry, do you want to comment?

Mr. HASKINS. I don't think we have made that determination yet. I think clearly there is a risk factor associated with the proposal, but we have not evaluated whether—what that level of risk is.

Mr. WHEELER. But Lee said you can still go after the money. If these funds were to go bad, you can still go after the money, right?

Mr. ROWE. Yes. I am speaking purely from a philosophical point of view.

Is there a risk factor between reserving the private capital and not having it pay in with the leverage in the same ratio? Does that have a moral hazard effect? I don't know. I am not an economist.

Mr. WHEELER. It sounds to me like this is not a risk issue, that it is really a budgetary issue.

Mr. ROWE. There is definitely a potential budgetary issue.

Mr. WHEELER. And there are more pros to doing it than downside.

Mr. ROWE. Whether or not a fund—you know, what investments a fund makes now and in the next year, and I think there are twenty-some-odd funds with commitments outstanding.

Mr. HASKINS. Well, there are 29 participating security funds licensed in 2004 that would potentially benefit from this provision.

When I say there is a risk element, I don't know that the risk is good, bad, or indifferent. We just have not evaluated. So I do not think we are prepared at this time to indicate one way or the other on that question.

I think it is an effort to deal with a looming problem, and I think it is an effort we need to evaluate. We recognize the issue that these funds face, and we are sympathetic to the problems that they are encountering. And we would like to be part of a solution if it is one that is—financially is not going to raise a cost that is inappropriate, but we have not made that evaluation yet.

Mr. WHEELER. And would SBA stop the bill if it went forward with any of these three proposals in it?

Mr. HASKINS. I can't comment on that at this point.

I think we look at it as a package and reach a decision. I would just like to turn the focus slightly on the aggregate area and just raise one potential concern we have there, is that within the existing law, there is a tiering structure on the leverage ratio.

At the lower levels, it is 3-to-1, at the highest levels it is 2-to-2. One concern we would want is to make sure we would retain the administrative ability to limit leveraged laws based on credit issues, notwithstanding the law allowing a higher leverage. So we want that to be understood, I think.

Mr. WHEELER. And that, you are talking about the change we have in the bill to raise the maximum single fund from 127 based on CPI to 150?

Mr. HASKINS. Correct.

Mr. WHEELER. And the varied—the ratios.

Mr. HASKINS. Right, that would use the tiering ratios.

Mr. WHEELER. Right. But I thought it already existed that you all control that, and so that is why the Committee was comfortable——

Mr. HASKINS. We do. We want to make sure we would retain that control.

Mr. WHEELER. And does the language still keep that provision? I didn't think we eliminated it.

Mr. HASKINS. I know that within the provision on the LMI and women/minority owned investments there is a caveat at the end that makes it clear that the Administration or the SBA is allowed to make adjustments on a case-by-case basis, based upon credit concerns.

I am not sure that provision applies to the prior one. I assume—we would hope that we would retain the flexibility to manage the program from a credit perspective in a way that makes sense financially to the taxpayer.

Mr. WHEELER. Does anyone at the table have a problem with that?

Mr. MERCER. I don't think it is an issue, because they control the licensing process. And if I come to the licensing process with a business plan that says 2-to-1 and Harry looks at me and says, 1.5-to-1 and we got a deal, I guess I either walk out or they have put their mark in the sand.

Mr. HASKINS. As long as there is an understanding that we manage the credit aspects of the program appropriately we are not as concerned with that provision as we might otherwise have been.

Mr. WHEELER. Thank you.

Are there any other comments on the SBIC Program, any other proposals or just general observations that we need to consider in trying to increase access to venture capital for small businesses?

Mr. ROWE. Yes. Well, there is this one concern that I would like to raise.

Mr. WHEELER. Are you speaking from the bill, or just general?

Mr. ROWE. I am speaking from the bill. This is S. 1662.

Mr. WHEELER. OK.

Mr. ROWE. Under the investments in low-income geographic areas—I mean, the current statute is clearly low-income geographic areas.

The bill has added women-owned and minority businesses. The only concern that I would raise is there is—the Administration, particularly the Department of Justice, always has a consistent concern with what could be viewed as preferences in finance programs that are based on race and gender.

We've always felt the low-income geographic determination essentially covers the same areas, both rural and lower income urban. And we target the same communities without triggering potential constitutional issues, particularly if we are setting leverage levels and putting preferences in a license in that fashion.

Mr. WHEELER. But——

Mr. ROWE. Again, that is something that the Department of Justice has always raised through us to the Hill.

Mr. WHEELER. Because our concern is that we would not capture, necessarily, all of those small businesses by women or minorities because we do not assume that they are all in low-income areas.

And we thought it was an important aspect to try to get at. If you have a better proposal for us, we would like to know it. When we looked at the SBIC data, for all the good it does, since 1998, the investments in firms owned by minorities and women has gone down. And also, the licenses to funds managed by minorities and women has gone down.

So we were trying to come up with something that was reasonable to provide a little bit of an incentive here. And so, if you have a different proposal, we would like to hear it, otherwise, we feel strongly that only trying to address this issue by looking at low-income geographic areas we risk the potential of missing investments or potential fund managers.

With that, should we move on to the New Markets? I'm sorry, did you——

Mr. ROWE. No.

Mr. WHEELER. I mean, we can talk about it——

Mr. ROWE. Well, I mean—yes. I am not going into the licensing, because this isn't really licensing oriented, it is just the investment level.

Mr. WHEELER. True.

Mr. ROWE. But yes, we can continue to work on it. There is more than one way to skin a cat.

Mr. WHEELER. OK. Thank you.

Well, with that, if we could turn to New Markets Venture Capital Program.

Kerwin, do you want to, representing the Community Development Venture Capital Alliance, give us an overview of the program?

Mr. TESDELL. Sure. Thanks very much, Kevin, and thanks to Senator Kerry and to Senator Snowe for having us here and focusing on this program.

I thought it would be helpful first to put things in context of the Community Development Venture Capital industry and then talk a bit about the program and some changes that we are interested in.

This Community Development Venture Capital industry is relatively new, when CDVCA was started 10–15 years ago, there were just a handful of funds managing in the tens of millions of dollars. People who intentionally went to economically distressed urban and rural areas of the Nation to practice the art of venture capital to create jobs and wealth in lower income communities.

We started discussions in 1999–2000 with the SBA, thinking about how the Federal Government can get involved to push this field forward from a public policy standpoint, for all the reasons that Dr. Rubin just gave. This industry was important to the Nation, and we looked at how the Federal Government could get involved in small ways to push the field forward.

And I think the New Markets Venture Capital Program does that very well. First of all, it provides the incentive, and really, the possibility for experienced venture capitalists to come to economically distressed lower income urban and rural areas and practice their art, and particularly people who are in the middle of their earning period who can make many millions of dollars elsewhere.

Even those who want to do that generally are not going to want to run a $5 million fund. They are going to want a larger fund. The leverage is very important for that. The other piece that is quite important is this Operational Assistance Grant.

And just to piggyback on what Dr. Rubin described and maybe go a little bit deeper, in these areas, often you do not find the sort of perfectly formed management team, with the CEO, and the CFO, and the marketing person, and all the intellectual property is all pulled together, and so forth.

Very often these are sort of diamonds in the rough, and that is what you find in the areas where Ray operates, and they need a little polishing. And that is what this operational assistance money does.

So maybe you have someone who really knows how to produce a product, but is not so good on the marketing side and needs some help with a marketing plan. Maybe you have a good team that is weak on the CFO position and you need a recruiter to be hired—to help hire—to find that person, recruit someone from outside of the area to make this company successful. And that's what that operational assistance money does. It really makes it possible for people to practice venture capital, something that works very well in Silicon Valley and Route 128 near Boston, and bring it to rural Kentucky, or inner city Baltimore and make funds viable. So that is really a crucial component and real difference with the SBIC Program.

Looking at some of the changes, minor changes, we are looking for in the program as it is being reauthorized, one is focusing on this operational assistance money. When we first designed this program, a very small number of funds, and there were several national foundations that were really focused on these funds, providing grant support for this new experiment.

This is no longer a new experiment. There are now 70 funds instead of 6 funds. And that kind of grant money is just not available. And the New Markets funds have found it very, very difficult to raise that operational assistance match. They have just been spending tremendous amounts of time out there as grant raisers as compared with venture capitalists, which is not where we want them to be spending their time. So that's one change.

The second change is just the targeting, just bringing that in line with the New Markets Tax Credit Program, which, as you know, was originally intended to work in tandem with the New Markets Venture Capital Program. They had the same name. There are several reasons that hasn't worked out so well, but this targeting alignment is an easy change to bring these two programs together.

And then third, giving funds a full 2 years of time to raise their private capital, particularly raising this kind of capital in economically distressed areas is a difficult thing to do, and once the starting gun shoots off when you have been conditionally approved, experience has shown that at least some of these funds need a full 2 years to raise the capital. So that's the third point we are looking for.

Mr. WHEELER. But in the overview of the program, Ray, do you just want to speak very quickly on why these differ—how these differ from other funds? You have a double bottom line.

Mr. MONCRIEF. We do. And quite frankly——

Mr. WHEELER. And you have an SBIC Fund and a New Markets Venture Capital Fund.

Mr. MONCRIEF. I do. As Lee Mercer says, I have one of everything.

[Laughter.]

Mr. MONCRIEF. Quite frankly, this is a parallel to the SBIC debenture program. As a matter of fact, there are areas that traditional SBICs, debenture-based SBICs just do not go because of deal size.

And consequently, what is interesting is that where I do what I do in Appalachia, there are not a lot of venture funds there doing it. And the ones that are there are looking for deals where they can do a first round of $5 million, a second round of $5 million, et cetera.

Greg didn't need that much money. Interestingly, what we are finding is that we do need these funds in these areas to do the smaller transactions, and actually to syndicate with traditional VC.

As a matter of fact, on many of my deals, I syndicate with traditional SBICs, because they do not necessarily have the segue way there. I have the segue way there. I am on the ground there. The deals are not inferior, they are just smaller. And I agree with that.

The other things is, I want to talk about this operational assistance. Having raised that type of money, I can literally burn up all of my management fee flying across this country asking people to contribute to operational assistance. And I am telling you, that does not exist. That money does not exist. You can get a $5,000 grant here, a $1,500 grant there—those sorts of things. And I can assure you that is the most brutal money there is to raise. I can raise five venture funds before I can round out 30 percent of regulatory capital that is required to match the SBA.

It just does not work, Kevin.

Mr. WHEELER. And to demonstrate how difficult it has been to raise, have any of the funds been able to raise the full $1.5 million, or 30 percent.

Mr. MONCRIEF. As a matter of fact, of mine, for example, I have a small regulatory capital on my New Markets Venture Capital Fund. That's 30 percent of $5 million, or $1.5 million.

Those that have a larger regulatory capital have to raise 30 percent of that regulatory capital. So it is up from 1.5 to 2, or 3, or 4, or 5, whatever their regulatory capital is.

I don't think any of them has raised their full match for the Operational Assistance Grant.

Mr. WHEELER. And recognizing that, if you want to say there was a flaw in the program, when the Department of Agriculture created a similar program, they did away with the match.

Mr. MONCRIEF. They did. As a matter of fact, when they were constructing, in the 2002 Farm Bill, the RBIC Program, they asked some technical issues that were the most challenging in the New Markets Venture Capital area.

And that was one of them, and they chose to draft in 10 percent of the private equity, up to $1 million, which is by far the better route to go, which is being proposed, as you well know.

Mr. WHEELER. Julia, do you want to make a comment, and then we will go to Greg and he will explain to us what a New Markets Venture Capital investment company has the potential to do?

Dr. RUBIN. Yes, I was actually going to say that I—I mean, I already mentioned that I thought the debenture in this legislation is too low.

I would actually propose another change to this legislation around operational assistance. I think, instead of saying the lesser of 10 percent or $1 million, I would make it a flat $1 million, like the RBIC Program, because the lesser of ends up being on the smallest fund possible, which is $5 million in private equity and a $5 million match in the debenture, which is a $10 million fund. You end up with $500,000 in operational assistance, and that is just not enough. You are looking at $50,000 per company, assuming about a 10-company portfolio, which is about what you are ending up with.

That's not a lot of money to play with when you potentially—you know, a lot of folks that are running the program now are ending up spending $250,000 easily getting the company to the point where it is ready for investment, and then doing work with them subsequently. And in a $10 million fund, you don't have the management fee to spare to do that kind of work. There is just no money there to play with. So the grant is just so critical.

So I would propose both raising the debenture piece to 2-to-1 leverage, and increasing the grant, and just making it a flat $1 million, which would not have, I believe, any significance budgetary impact, because you are still looking at $20 million, if I am not mistaken, as a program level.

Mr. WHEELER. We did reduce the authorization level from $30 million to $20 million based on the change.

Dr. RUBIN. Right. I'm sorry. You could do it with the $20 million if you are looking at——

Mr. WHEELER. Right. Because we did factor in the maximum $1 million per possible 20 funds.

Greg, do you want to tell us your story—you have New Market Venture funding. Tell us what this meant to your company, the jobs you provided and what the program does, and where you are located—why it made such a difference.

Mr. HARMEYER. Sure. Thanks for having me here today. I really appreciate the opportunity to discuss these programs, and I have become very educated on some of this.

Honestly, I am not an expert on the programs themselves. I am coming at it more from the other side of this.

We are—I will give you a brief thumbnail of our company so you have some context. Our company, Tier One Performance Solutions, we are about a 4½-year-old company, a software and services company, that works with large organizations. FedEx is our largest customer. You mentioned that they were an SBIC company. So there is obviously some derivative effect—but Proctor and Gamble, Wendy's International, large companies like that, helping them with online learning and knowledge programs to get their workforce educated, to get their customers educated.

Most recently, we have begun working with the United States Air Force on helping transition knowledge within their engineering ranks as their engineers begin to approach retirement.

One of the things we found—we were about 2½ years into the company when—first of all, we started the company with personally guaranteed debt, which is not uncommon.

I think the comment that venture capital is a misnomer I agree with completely. I think your options really are debt or Angel investment, typically. We went the debt route. There are limitations to that in a capital market for a company that is small, because most banks will—you have to have multiple guarantees and collateral. And you have limitations to that, and many banks still won't lend you what you need.

And so we reached a size growing that model where we realized, and it was really when the government opportunities began to open up to us that we needed more capital to be able to grow effectively.

The options for you at that point are to look at Angels and to look at larger private equity firms. Most private equity firms you talk to will say to you, OK, it is great that you are looking for $500,000–750,000, what would you do with $5 million?

Well, there is not an alignment there. What they want out of $5 million—we can take in $5 million, but it doesn't make sense for our people, for our customers, for what we are trying to do, and the timing of their investment is not right.

So our options were really limited, and it is one of the reasons I think the New Markets Venture Capital Program is critical. Our options were limited both by the size of the investment we were doing, so there are a limited number of investors willing to do that, and also limited by our location. We are in Covington, Kentucky, you know, a rural State, and the issue there is deal flow.

There are not enough investors there. There are not enough deal opportunities for investors to want to be there, and so it is a chicken and egg thing. There are some good companies there, but there are not enough of them. And so there is not enough attention from private equity investors to want to invest in those areas.

So we happen to be located in a HUBZone, in a very developing area of Covington, Kentucky. So the opportunity to work with the Southern Appalachian Fund, which, as you know, is part of the New Markets Venture Capital Program, was a very appealing one to us.

It was also appealing because working with purely Angel investors, which is essentially the alternative, you do not get access to the expertise, the networks, and the experience in helping grow businesses that a professional fund will have, and like Ray's company would have. And that expertise is significant in and of itself, especially when we were looking at growing into the government sector.

Angel investors, this a generalization, but often tend to be passive investors, or they know a limited area of what they do, but they are interested in getting a return. They believe in you as a person or as an individual, but they are not necessarily there to help foster and develop the company. So that is a limitation of that approach.

So the fit, I think, was significant. Another limitation we had in raising capital is—you mentioned job creation. Well, our business is partially software, and a large part services-based. A lot of investment companies do not want to invest in services-based companies because they do not scale very well. They particularly have a perception that they will not scale well in a rural area, because of the access to the people that you need to grow.

Of course, that is where a lot of job creation comes. I think over 90 percent of the job creation in the U.S. is in services-based companies. And so there is another issue there.

The Southern Appalachian Fund obviously has other interests in mind, and one of them is job creation. And so it is very much aligned with what we are trying to do.

And so the fit there—I honestly do not know, if we had not had the option to work with the Southern Appalachian Fund, that we would have aggressively pursued additional capital. We could have been found growing at a much more limited pace without raising capital, but the opportunities for a company in Kentucky to bring in Federal dollars to do work for the government are few and rare, but it was there. And so it gave us an opportunity to grow.

We are now around 40 full-time people. We do a lot of work with other contractors, which is just a different form of employment. So if you count all the people that we pay, it is probably in the 40 to 50 range, you know, in a small growing area of Covington, from three people when we started.

We've also been very fortunate and honored to win the Kentucky Small Business Persons of the Year from the U.S. SBA. So we are thankful for that. We were named the U.S. Chamber of Commerce Blue Ribbon Award winner. So we have been honored to have a lot of successes, but it really has been largely because of the partnership we have been able to get—both the funding and the assistance that we have gotten from our investors.

Mr. WHEELER. And what does it mean to your community, your company to have this presence there?

Mr. HARMEYER. It is very significant. I am glad you asked that.

We actually relocated. And because we are invested in from a New Markets Venture Capital Program, we were limited to stay in the HUBZone area, which was a good thing. We weren't necessarily looking to leave, but it certainly kept us there, which I think is worth noting.

We moved into what was a 150-year-old building that has been renovated and is the centerpiece of downtown Covington. We've made the headlines of the local paper two or three times because of that building. And it is very much a sign for everybody who goes through there that the area is developing, that there is growth.

Within our block, there are probably at least a dozen technology companies, most of them a little younger and smaller than us, and we are helping lead the charge, but we collaborate—many of us collaborate on multiple deals.

So it is fostering other things as well. We probably collaborate with a half dozen other companies within the same block on various opportunities. So it is a virtual cycle: The more you can get businesses there that are going to succeed, the more it is going to help others succeed and attract more businesses there.

Mr. BERGER. What about job creation?

Mr. HARMEYER. Well, as I mentioned, I think job creation is—it is a primary focus of your business because the large part of what we do is professional services, and we draw on the many universities in the region to get our people.

I do think that is a limitation in many private equity firms, is that they—I don't think this is literal, but I think a private equity firm's typical best deal would be infinite scalability and no people.

And not out of any—I don't think that is bad. It is just you are looking for very high growth velocity that you can turn over in 3 or 4 years.

That is not the pace that we are on. And again, the interests of the Souther Appalachian Fund are more aligned with the job creation and what it does for the community, which I think is a very positive things, because, again, for managing investors in a relationship and common ownership in a company, you have to have the same interests in mind all along. And if we had an investor who was opposed to job creation and we were actively looking to grow our workforce, it causes tension in terms of where you are going to go and what you are going to do.

Mr. WHEELER. And it makes the point that if the SBA's programs are supposed to bridge the gap, fill a need, that the private sector is not doing it. Even though they are doing good things, they are doing other things, and therefore, without this, there would not be——

Mr. HARMEYER. There is no question in my mind that the statistics that Dr. Sohl put forth—I have never seen these before, but it absolutely typifies the experience that I have seen out there, is that there is this capital gap.

I mean, we want a startup, but we are not—we may do a Series B someday with a private equity firm of a much larger round, and that is certainly something we will consider, but we were not ready for that. And there is this gap—a shortage of companies willing to invest at that time.

Mr. WHEELER. Thank you.

Dr. Rubin.

Dr. RUBIN. I just had one quick comment as a follow-up to what Mr. Harmeyer said.

I think if you look at the companies that have received New Markets Venture Capital money, I do not know the exact number, but it is well over half that have actually moved into a low-income area, which is great for developing those areas.

I think where the problem has, for me—is, in terms of targeting, and why I support some modification is you cannot move a manufacturing concern 100 percent of the time. What it pushes the funds to do is technology and some manufacturing that is easier to move. But if you have a company that is larger and that really has a reason why the facilities cannot be moved at that time, it precludes those investments.

So I think it is really great to be able to move those firms that you can to where they can really have a great economic impact, but it is nice to have that flexibility too for when you cannot do that to invest in manufacturing, which is what you are trying to do with this legislation.

Mr. WHEELER. You are speaking to the change in the legislation that we would line the program with the New Markets Tax Credit so that you could hit not only geographies but targeted populations——

Dr. RUBIN. Right. Right.

Mr. WHEELER [continuing]. To a certain extent.

Dr. RUBIN. Right.

Mr. HARMEYER. I would like to comment on that.

It is a good point, and I do not know the specifics of what you guys are talking about from a legislation standpoint, but we literally were on the border of whether we qualified or not—literally on the street block border of whether we qualified or not and, in moving—two things. One, we were not sharp. First we had to do some research. It would have been unfortunate if we did not qualify, because it was such a natural fit.

Two, in moving, it did very much limit us to—we ended up in a good place, but it very much limited our ability to look at alternatives. And so I think there probably is—it does provide some limitations that may be taxing at times and constricting.

Mr. WHEELER. But you are in a HUBZone?

Mr. HARMEYER. Yes, we are.

Mr. WHEELER. That is going to make Senator Bond very happy, since he is the father of the HUBZone Program.

Mr. MONCRIEF. As a matter of fact, Kevin, every one of our investments are in a HUBZone.

Mr. WHEELER. I'm sorry he's not here. It would be very popular.

SBA, would you like to make any comments just to summarize what they said.

Mr. ROWE. There are a couple. We were just talking—looking at this overnight, and all.

There are a number of just technical points we would raise with you guys, because—trying to figure out, particularly under the Operational Assistance Grants.

What we understand here is that this would set the amount at 10 percent of private capital or $1 million, whichever is less, and remove the matching requirement.

But what it doesn't do, and this goes to what Mr. Moncrief was talking about, is that it does not change the 30 percent of capital operational assistance from outside funds requirement.

Mr. WHEELER. I thought that we—are you saying that it is a drafting error?

Mr. ROWE. Yes.

Mr. WHEELER. OK. Thank you.

Mr. ROWE. If that is what you are trying to do, it did not do that.

Mr. MONCRIEF. He is exactly right.

Mr. WHEELER. Thank you. We will change that. I am happy that you support it.

Mr. ROWE. Just pointing that out to you.

One of the other issues that we just noted with the small manufacturer participation agreements, the only concern we have on something like that is locking a fund into a participation agreement that might limit their, one, opportunity to invest outside that area of, say, small manufacturers, and two, because it might limit their diversity, you know, limit their liability. So we always have a concern with that.

That being said, we do not have a problem with the idea that small manufacturing businesses in particular should be a target. I don't know whether that is better served as a larger programmatical, in some sense, rather than an individualized——

Mr. WHEELER. Make it a goal? I see.

Mr. ROWE. Rather than individualized to particular funds and particular participation agreements.

Mr. WHEELER. Well, John Kerry mentioned this in his opening statement, and he is concerned about that, too. And I think that is why the language differs from the House side in the sense that it says, "To the extent practicable." I think that is in there.

And then there is also a construction qualifier. But maybe doing it as a goal is a better way to approach it. Congresswoman Moore felt very strongly about it, because in Wisconsin they have been bleeding manufacturing jobs, and so they were trying to use this as a tool.

Mr. ROWE. Absolutely. And the only other thing is when we were looking at the change from low-income geographic area—this might create an administrative problem for the Agency, just simply because the programs that we have now help us geocode New Markets Venture Capital firms, and we are not sure whether we can make it work this way, but that would be an administrative burden for us rather than anything else.

Mr. WHEELER. If you want to put the money in your budget we will support it for you to be able to afford that.

Mr. ROWE. The whole thing is we were thinking, we are not even sure you can make a computer program that will tell you that.

Mr. WHEELER. But if we can do it for the New Markets Venture Capital Program, can it not be possible—and they are doing it for RBIC, too.

Mr. ROWE. Honestly, they have a whole licensing division at Treasury that does New Markets Tax Credits. So I do not know how they do that.

Mr. WHEELER. OK.

Mr. ROWE. That's the only other thing, is linking to New Markets Tax Credits—you will have to ask the Treasury folks what sort of budget impact they think that would have expanding it.

The only other thing I would point out, and maybe Ray can speak out to this a little better, the timing on a New Markets Tax Credit is, as I understand it, 7 years, and I do not know how that matches up with the life cycle of a fund and whether that affects its utility at all.

Mr. WHEELER. Would anybody from the industry like——

Mr. TESDELL. Sure.

I mean, you are absolutely right. There are other difficulties with making these two programs work, but this was one that we thought was a simple fix, and I think it has other benefits, as Dr. Rubin mentioned.

So it seemed like a good time to do this.

Mr. WHEELER. Right, because it is more attractive to the investors, it makes it simpler, also, you get to those targeted populations where it is needed.

So those benefits outweigh the possible out-of-sync fund of a tenure fund versus a 7-year credit, right?

Mr. TESDELL. Those are other issues that we will have to deal with other Committees, and so forth, but bringing the market area definitions together seemed like a good step.

As to the administrative burden of doing this, the New Markets Venture Capital Program does it, the CDFI Program does it. At least this work has been done by other agencies that you folks will be able to piggyback on.

Mr. WHEELER. Can you answer just one question, because some people are concerned about adding targeted populations.

Why is it important to also reach the targeted populations and not just the geographic area? What is the justification for that?

Mr. TESDELL. Sure. Just on a very broad level, there are low-income people who need jobs that do not necessarily live in particular census tracts. So this addresses that issue.

Mr. WHEELER. Or the businesses that could provide the jobs to those people that need it that are not necessarily located there.

Mr. TESDELL. Yes. Yes, I am sorry. That is correct. You said it better than I did.

Dr. RUBIN. There is another issue, which is that census track designation changes every census, and 10 years is a really long time. So fund managers I spoke with highlighted that, when they were looking at the geography, it had a completely different qualification than when they actually started making investments because things changed on the ground. And there might have been a lot of eligible areas at the time that they were putting a fund together, and by the time that they actually started investing, that eligibility lapsed, because the new census came through, and suddenly they were not eligible.

So it is just a very blunt instrument with which to target. And sometimes it works great. Sometimes the company is in the right place and it works wonderfully, but it just does not always work.

Mr. WHEELER. OK.

Mr. MONCRIEF. One comment about the geography, as well.

Tier One is a classic example of just that point. I am the only New Markets Venture Fund that used the New Markets Tax Credit to partially capitalize the regulatory capital.

And consequently, I have multiple tests when I do a deal. I mean, I have a lot of tests. One of which is the geography.

In this particular case, to Tee's point, the New Markets Venture Capital piece recognized Greg's address as a qualified area. On the other hand, the New Markets Tax Credit geo-plotting software said it was an ineligible census track.

And so consequently, I had to make the decision, and I was able to do some investment outside the NMTC area and consequently made the investment regardless.

So there are a lot of incongruencies just in the base definition of what the geography is. And you are right, there are many times a situation where we get investment on a company that is sitting on a corner, and the people that are going to work in it are across the street, and we cannot make an investment.

Mr. WHEELER. But Greg qualified because of the HUBZone piece, which is separate than those tracts that are created in the definition. And the Committee intends to preserve the HUBZones, the Empowerment Zones, and the Community Reinvestment——

Mr. MONCRIEF. For the venture capital piece?

Mr. WHEELER. For qualified areas. The Committee intends to keep that.

Mr. MONCRIEF. Absolutely.

Mr. WHEELER. So while you said that it was not—he would not have been an eligible investment by the tax credit.

Mr. MONCRIEF. That's correct.

Mr. WHEELER. If we adopted the tax credit, my fear is that you are telling us that now we could not make the investment, but I am saying the part that made him eligible—he would still be eligible. We are preserving that.

Mr. MONCRIEF. Yes.

Mr. WHEELER. So we are simplifying it. We are getting the advantage of simplifying it by lining it up with the tax credit, but we are preserving those pieces that capture—we are preserving those eligibility requirements that captured Greg's company.

Mr. MONCRIEF. Yes.

Mr. TESDELL. Just to add a couple of other points. One is that I understand in many rural areas, you have very large—geographically large census tracts that often combine very low income areas with higher income areas.

So for example, in Maine, along the coast, you may have a number of high-income people along the water. You move in 10 miles inland and you have very low-income areas.

You combine those two together, and that is not a low-income census track, even though you have pockets of poverty elsewhere. So that's an important issue.

And then also, just to reassure everybody here, the process that a fund has to go to satisfy the regulatory requirements approving that you are—it is sort of the flip side of your administrative burden. There is a big burden on the fund. Funds generally are not going to do this unless they are sort of mission-driven community development venture capital funds.

Not a lot of them are doing this in CDFI or New Markets Tax Credit. So this is not some big loophole that someone is going to drive a big truck through. It is actually a small opening for very mission-driven funds to do what they need to be doing in communities.

Mr. WHEELER. Matthew, did you have any questions?

Can we also talk about the legislation—there is a provision that would create an office within the SBA's investment division that focused strictly—it is a New Markets Venture Capital office, and it would have a director who is not a political appointee. And it is in the bill because we have heard concerns over the years that there have not been the resources dedicated to this office.

And I wondered if anyone here could explain to us why they see the need for this office, or if SBA wants to comment—you don't need to, but if you want to say you would not like it.

Mr. ROWE. I think the only comment I would have is that as long as there is a program there is going to be an office. I would definitely say we have a problem with it being senior executive service, simply because there are a limited number of those positions in the agency by OPM rules.

And GS-15, 14, something like that, but SES is—people like Mike——

Mr. WHEELER. OK. But you are OK that it is not political.

Mr. ROWE. Yes. I mean, we are not going to worry about that.

Mr. HAGER. I guess the issue—would be interested in the issues driving that, that recommendation.

Mr. WHEELER. For instance, where do the funds go now in the SBA when they have questions or if somebody is overseeing them.

Who do they talk to at the agency? How many people are overseeing this?

Mr. MONCRIEF. There is one individual. I guess Harry can answer that.

Mr. HASKINS. We have one individual working directly on the program. That individual reports to me.

Mr. WHEELER. And is one person really sufficient to oversee and manage six funds, particularly if the intention of this legislation is to grow as many as 20 more?

Mr. HASKINS. I think, if this program were to grow, the answer is no, one individual would not be sufficient.

We are trying to develop some redundancy within the office to deal with the issues, such as if the employee were to leave or go on vacation or what have you.

As a practical matter, we also administer the SBIC Program and the individual analysts within the SBIC Program may well handle 25 to 30 funds.

So we are not sure there is a workload imbalance on a relative basis between the two programs.

Mr. MONCRIEF. The one thing that does beg to be commented about is the uniqueness of the New Markets Venture Capital Program versus the traditional SBIC debenture program.

Things, for example, the approval cycle of the operational assistance.

The individual that reports to Harry does an analysis, an in depth analysis and comments back on his approval of an operational assistance program. And I don't know what redundancy is in the investment division for that, but those are extraordinarily important to be delivered on a timely basis.

And so, having someone that is truly knowledgeable about the New Markets Venture Capital Program is extraordinarily important.

Mr. WHEELER. Well, I think it is important to have the institutional knowledge there. And it is a specialized program. So I think that is a very good point about having a backup. I am glad SBA is looking to put that in place. I think it is a very important protection.

In general, is SBA supportive of reauthorizing the New Markets Venture Capital Program?

Mr. HAGER. You know, it is still in its harvesting stage. We need to make sure that we continue to monitor it. We are really pretty early in the program right now, but so far, we have no reason to believe it is not a very good program, and we like what we see so far.

Mr. WHEELER. Have you been able to, Mike, visit any of the New Markets Venture Capital companies that they have invested?

Mr. HAGER. I have not physically been in any of those six. It is something that I would like to do.

When you stack up all the other things that we have going on right now, it—that is a good idea.

Mr. WHEELER. And has the administrator been able to visit any of the companies like Greg's?

Mr. HAGER. I don't know.

Mr. WHEELER. We just think it is important because, while the current administrator is very supportive of investments in these areas, it was very hard to get this program implemented and the Committee had a lot of struggles.

And so our concern is that there was lack of support, even though no one was really going out to see what these funds were accomplishing.

Mr. HAGER. I will make this easy. I will commit to do that soon.

Mr. MONCRIEF. Let me be the first to invite you.

[Simultaneous discussion.]

Mr. HASKINS. The analyst working on the program has visited some of the portfolio companies.

Mr. WHEELER. Oh, good.

Mr. HASKINS. And we have an examiner that has also visited both the funds and the companies as well. So we have not completely forgotten.

Dr. RUBIN. And the assessment I am doing is for the SBA. So they are very supportive of that.

Mr. BERGER. I have one more question for SBA.

But does SBA have an issue with changing?

I know, Tee, you gave us a technical correction on the Operational Assistance Grant piece, to remove the 30 percent, which I think you were spot on about, but does SBA have an issue with changing the Operational Assistance Grant formula to more align with the RBIC formula.

Mr. ROWE. Honestly, we realized, as Ray said, that is probably the biggest hurdle that a New Markets fund has.

You know, when the licensing occurred and we had the conditional licenses and they raised their private capital, that was where everybody was scrambling to get things done to get their final license.

So I couldn't give you a categorical yes, but obviously it appears that, if we looked back at lessons learned, that is—it is pretty pointless to have a program with a hurdle that is almost impossible to overcome.

Mr. WHEELER. Thank you.

Kerwin.

Mr. TESDELL. If I could just follow on from that. Thanks very much.

Just sort of big picture, the public policy interest is to get experienced venture capitalists to do venture capital in these areas where they are not currently doing it. And without operational assistance, or if the Operational Assistance Program is too difficult to use, that incentive goes away.

Otherwise, why not just—not just—why not start an SBIC in these areas?

If you want to provide incentive, it is the operational assistance that does that. If operational assistance does not work, you do not have incentive.

Mr. WHEELER. So we can build capacity.

Mr. TESDELL. Right. So this is absolutely key to the program.

Mr. WHEELER. And there was a component of this when this issue came up in 1999. The late Senator Wellstone had a provision that was specifically for capacity building.

Mr. TESDELL. Yes.

Mr. WHEELER. So while that didn't get adopted, unfortunately, I think it shows the importance of why we should keep the grant, so that you can spawn more.

Mr. TESDELL. Yes.

Mr. WHEELER. You know, may I ask one other question of SBA?

Ray piggybacked on what Lee was saying about changing the 20 percent maximum investment in a fund. Does that limitation also apply to the New Markets Venture Capital Funds?

Mr. HASKINS. It does.

Mr. WHEELER. It does. OK.

Are there any more comments that anyone would like to make before we wrap up the roundtable?

Mr. FERREIRA. My name is David Ferreira, Director of Government Affairs at the Hispanic Chamber of Commerce.

We are an organization. We have over 250 affiliates—chambers, locally, and our members of our chambers amount to less than half a million. We try to represent over 2 million Hispanic-owned businesses nationwide.

Obviously, our perspective is we suspect similar to the Black Chamber of Commerce: One of looking from the outside in. So obviously, our encouragement would be to find ways to educate and promote. And obviously promotion is not always equal, and not all forms of promotion are equal.

We would like outreach that is genuine and can lead to actual minority-owned SBICs. We are unaware of any Hispanic-owned SBICs. I am not saying that there are not any. And we believe some of the issues, whether they are by construct.

We believe that those some of these issues, whether by construct, assigned coin, sit-ins, outreach, education—we believe that those issues should be addressed towards trying to—lead to at least a minimal number that is more representative of our minority business community.

Mr. WHEELER. And the Committee is concerned about that, too.

We talked a little earlier about that. To the businesses that got the SBIC and the New Markets Venture Capital Funds, how did you find out about the programs?

Mr. HARMEYER. I'll answer.

There is an organization in the State of Kentucky that manages some of the grants on behalf of the State of Kentucky. And they do a good job of staying attuned to all the investors throughout the State. And so they did the introduction for us.

But I will quickly add to that marketing and promoting these things is very much needed, because I do not know how many small business owners I talk to who do not know about programs like this and where to go.

Mr. WHEELER. So you don't think it was just luck that you stumbled upon them? You knew to go to this State resource and ask them to do the matchmaking or help you identify sources?

Mr. HARMEYER. Well, we invested quite a bit of time in networking with those organizations, and it is a big investment of time.

So our relationship with that organization in the State was probably directly attributable to this, but most small businesses probably cannot afford to do that or do not do it or whatever the case may be.

It is hard to make the connections. There is no question.

Mr. WHEELER. So how would somebody promote it? What do you think would be an effective way for the SBA to increase outreach and make people aware of them?

Mr. HARMEYER. That is a good question. I suspect doing more through the local chamber of commerce organizations, because that is one area that small businesses do stay pretty connected to, to make sure that people understand what the programs are, why they are valuable, who they are fit for.

I mean, a lot of this, for small business owners raising capital for the first time—there is a lot to learn, and to understand all the differences—and so I think just trying to simplify it and try and educate people in simple terms on what the options are and why these programs exist and who they are suited for I think is helpful.

Mr. WHEELER. For instance, we found an issue in Massachusetts where—when we started dealing with the Hispanic business owners—they were not going to go through the universities. They were really networking through their churches. And they were telling us, please—sometimes the university campuses are not in the right location for us.

There is not a trust factor there. And so you need to find a way for separation of church and state somehow to do outreach and build awareness through that.

That was just in Massachusetts, but that speaks to your issue that they were—we weren't really looking at the issue of who we were trying to reach. We just had one way of trying to advertise it.

And this is not a criticism of SBA. It is something that we are all struggling with of how to—if we believe that these programs serve a purpose, how do we make sure that more people know about them.

And so possibly that is one way that chambers of commerce—Ed, how did you find out about it?

Mr. TIERNEY. Well, we had an associate, too, that was familiar with the program and had reached out.

But I would emphasize again what Mr. Harmeyer said, that we are small businesses, and there is a tremendous amount of multiple hat-wearing and responsibility at every level in senior management.

And it is difficult to invest the time and to reach out and to search out—and for somebody who has not been through the process of a capital partner, it is a tremendously demanding learning experience.

So I can imagine for people trying to access this without that previous knowledge can be tremendously difficult. and I would suspect through chambers of commerce or the like, or something similar, community-based, would enhance the chances that somebody might find out about these programs.

Mr. WHEELER. Does SBA have tutorials on how venture capital works for companies and what they should be looking for?

Mr. HASKINS. I believe, on the web page, there are tutorials on securing financing, an element of which is addressing the venture capital industry.

How helpful it is, I really don't know.

Mr. WHEELER. Because Greg had mentioned how important the relationship is and just how difficult it is to find that match.

It is not just about money, but there are other elements that you should be looking for.

Mr. HARMEYER. No question. No question about that.

One other question would, I think—most communities, or many communities, certainly in our region. I suspect it is true across the country—have incubators of different sorts, and strengthening the connections of these programs to these incubators, I mean, that is one place that small businesses who really think they are going to grow will start in terms of looking, because they have heard about this and so that is one are that they can get educated through.

Mr. WHEELER. OK.

Mr. HARMEYER. I don't know what is being done.

Mr. WHEELER. The Hispanic Chamber just mentioned the need for more licenses to go to, say, Hispanics. We have been concerned about it. We talked about them getting access, but we need to talk about access for women.

Dr. Sohl, you just completed a study on women in venture capital. What were the findings there?

Dr. SOHL. Actually, women in SEED state capital. There was not much venture capital because they do not do SEED. But it did include some SBIC fundings and did include Angels.

And it turns out—and it was interesting from some of the comments. When women got in front of investors, they did quite well. In fact, they did better than their male counterparts. The problem was getting them in front of the women.

So I think it is the same issue as you said, trying to draw out—these are sources of capital that you should consider applying for and/or actually following through, because we measured this seek and yield rate.

If you are looking, they were actually yielding quite well, but they just were not looking at the high levels. So I think there is this big information gap that is floating around.

One possibility—most States have SBDC offices, too, right? I mean, that's another one. And plus the State's securities offices. Businesses have to register somewhere. Usually that is another stop gap. Those are two places I know.

I know—I am actually on the board of a double bottom line fund, and we deal with that information through the State securities offices and the SBDCs. And those are in place already.

Mr. WHEELER. OK. Thank you.

Any other comments before we wrap it up?

Just one last word, if anyone has any technical changes, please let us know. We do plan to mark this bill up at 10:00 a.m. on Tuesday, and we want it to be as good as it can.

Thank you.

[Whereupon, at 12:16 p.m., the roundtable was adjourned.]

PREPARED STATEMENTS

NASBIC
America's Small Business Partners

Statement
of
Thomas W. Gorman

Seacoast Capital
55 Ferncroft Road
Suite 110
Danvers, Massachusetts 01923

Before The

United States Senate
Committee on Small Business & Entrepreneurship

Regarding

Legislative Proposals for The SBIC Program

June 21, 2007

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Chairman Kerry, Ranking Member Snowe, and members of the Committee:

Thank you for inviting me to participate today in this roundtable discussion concerning issues related to SBA investment programs. In our case, as a Small Business Investment Company, I am particularly interested in issues related to that program.

By way of introduction, my name is Tom Gorman and I am a co-founder and managing partner of Seacoast Capital. Seacoast was founded in 1994. Before Seacoast, I was a Senior Investment Manager of Signal Capital and acted as Assistant Treasurer for Signal Capital responsible for all borrowings and short-term investments. Prior to joining Signal Capital in 1988, I was a Manager of Corporate Finance for General Motors Corporation and a Lending Officer with the Shawmut Bank of Boston.

Seacoast Capital invests mezzanine and equity capital in small, growing companies led by strong, entrepreneurial management teams. We invest in high quality U.S. businesses that are market leaders in our target industrial sectors of manufacturing, distribution, business services, and industrial technologies. We look for companies in growing or fragmented industries with revenues in excess of $10 million and operating earnings in excess of $1.5 million. The investment opportunity may be an acquisition, management buyout, or internal growth. We have a particular interest in companies located in underserved urban and rural markets. In all cases, we partner with managers who have proven track records and significant equity stakes. BISCO Environmental, Inc., led by Ed Tierney, is a great example of the type of company we like to have in our portfolio, and I am delighted he is here today at the invitation of the Committee.

Seacoast Capital invests through two partnership affiliates licensed as Debenture SBICs under the Small Business Investment Act of 1958. In addition to the U.S. Government, our investors include strategic institutional and individual investors who enhance our national presence. With over $200 million of funds under management and over 35 investments since 1994, Seacoast Capital is among the nation's leading mezzanine investors in our target small company sector. We think our demonstrated ability to respond quickly and offer value beyond dollars makes Seacoast Capital an excellent financial partner for the businesses in which we invest.

Turning to the purpose of my appearance, I would like to express my strong support for the legislative proposals made by the National Association of Small Business Investment Companies. They are addressed in greater detail in the statement of NASBIC's Chairman-Elect Steve Vivian. Like Steve, I also serve on NASBIC's Board of Governors. I can assure you that our proposals are made with only one goal in mind: to simplify where possible what is considered a complex program and to make changes that will make the SBIC program more attractive to investment professionals such as myself and to the critically important private investors who invest in our funds. We believe the proposals we have made will do that, and do it in a way that does not increase the risk of loss to the government. The SBIC program is a great program, but like any program it can be improved. Making improvements this year will help mend the reputation of the program, a reputation damaged by the government's abandonment of Participating Security SBICs. That is important if we are to see growth in the Debenture program that will at least partially offset the contraction related to the wind-down of the Participating Security program.

If enacted, NASBIC's proposals we have will do three things:

1. make rational the rule related to the maximum amount that may be invested in a single portfolio company without an exception approved by SBA;

2. stabilize, rationalize, and simplify the rules related to the maximum leverage that can be drawn by any one SBIC or group of co-managed SBICs and the size of target companies that leverage is to be invested in; and

3. provide some measure of relief to the remaining Participating Security SBICs that will otherwise never have the benefit of the leverage anticipated by both SBA and the SBICs when they were licensed.

Thank you for considering these proposed changes. We understand that they are technical in nature and difficult to understand for those who do not live and breathe the issues on a daily basis. However, they address important issues and we believe that if they are enacted the SBIC program will be better able than it is today to attract new managers and new private capital for investments in U.S. small businesses.

BISCO Environmental NEEP Systems

Soil and Groundwater Remediation Equipment

June 18, 2007

United States Senate
Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

Chairman Kerry, Senator Snowe, and members of the Committee, thank you for the opportunity to appear today to help in any way I can as the Committee considers issues related to the Small Business Investment Company Program. Thank you for your interest in the story of BISCO Environmental as a portfolio company of an SBIC.

BISCO Environmental offers full-service design / build capabilities utilizing a broad range of technologies to environmental contractors and consultants to the petrochemical industry, chemical manufacturers, military and governmental entities. More information on BISCO Environmental can be found at www.biscoenv.com.

BISCO Environmental was founded in 1990 as an outgrowth of Boston Irrigation Supply Company, a distributor of irrigation supply systems for the Boston and surrounding New England areas. By 1995, BISCO Environmental had evolved into a leading provider of integrated Soil and Groundwater Remediation Equipment in the New England and metropolitan New York regions. By the year 2000, having outgrown its owners understanding of the industry and their willingness to further invest in its development, BISCO was consequently purchased by William Horlick Company, an existing subcontractor.

Between the year 2000 and 2005, BISCO Environmental once again realized substantial growth, expanding its business geographically and widening its customer base to include national contracts with major oil companies such as Exxon Mobil Corporation. This rapid growth once again strained private ownership's ability to capitalize the company's growth, and a capital partner was sought to sustain the company's growth initiatives.

Seacoast Capital Partners II, L.P. invested in a management buyout of BISCO Environmental in 2005. Through capital provided by Seacoast and Sovereign Bank, the senior lender introduced by Seacoast, BISCO Environmental has made several important steps to reinvigorate this business:

- Hired sales and marketing representatives in several new areas of the country;
- Developed and introduced a new product line for remediation of oil spills through "in situ" oxidation;
- Moved from cramped, compromised facilities in Randolph, MA to a 22,000 SF state of the art facility in Taunton, MA;
- Acquired Northeast Environmental, a small, struggling competitor that will broaden our product line and increase jobs in Taunton;

- Hired a team to develop an environmental instrumentation rental business to increase contact with our primary customers as well as generate cash flow; and
- Developed a plan to significantly expand our California operation through licensing a line of thermal oxidizers.
- Relocated the Southern California office to a larger more modern facility to support the regional growth.
- Through contacts provided by Seacoast Capital, BISCO applied for and received a grant by the State of Massachusetts to implement Lean Manufacturing Training with the assistance of the Massachusetts Manufacturing Extension Partnership (MEP)

All of these steps have combined to make BISCO Environmental the unmistakable leader in the integrated remediation field with a broad customer base ranging from large oil companies including Exxon Mobil and Chevron Texaco, to environmental consultants, and other small businesses. Seacoast Capital has been instrumental in supporting all of our efforts to grow BISCO Environmental and providing counsel to the Company's management team.

Sincerely,
BISCO Environmental

Edward F. Tierney

Edward F. Tierney
President

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NASBIC
America's Small Business Partners

Statement
of
Stephen Vivian

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Before The

United States Senate
Committee on Small Business & Entrepreneurship

Regarding

Legislative Proposals
for
The SBIC Program

June 21, 2007

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Chairman Kerry, Senator Snowe, and members of the Committee:

Thank you for inviting me to participate today in this roundtable discussion concerning issues related to SBA investment programs. In our case, as a Small Business Investment Company, I am particularly interested in issues related to that program.

By way of introduction, I am a partner with Prism Capital, a team of six professionals managing two SBICs: Prism Opportunity Fund, a Participating Security SBIC licensed in 1999, and Prism Mezzanine Fund, a Debenture SBIC licensed in 2003. As I indicated at the Committee's budget hearing in April, we have a combined total of approximately $195 million under management in the two funds. Our main office is in Chicago, Illinois. We have satellite offices in Seattle, Washington; Englewood, New Jersey; Minneapolis, Minnesota; and Milwaukee, Wisconsin. I am also NASBIC's Chairman-Elect, scheduled to assume that position in October.

At Prism we invest in growing industrial companies located in the Midwest, providing capital and strategic advice for internal growth, recapitalizations, mergers, acquisitions, and ownership changes. Our Advisory Board members have decades of executive experience and have successfully navigated the full spectrum of market conditions through their careers. They provide strategic insight and function as a management consultant to both our funds and our portfolio companies. Their invaluable insights and industry affiliations create tactical advantages and opportunities typically not available to this market. Our goal is to provide all of the financial and advisory resources necessary for our portfolio companies' success.

We are committed to backing exceptional entrepreneurs who have the vision, drive, talent, and business models to be leaders within their industries. We understand that growing an exceptional business is a lengthy, complex process that more often than not includes many unexpected developments along the way. Thus, we are a patient investor, investing with a horizon of between three and seven years depending on the requirements of the small businesses we invest in. We also invest with the mindset that growth requires additional capital and reserve for follow-on investments. We maintain an extensive network of contacts in the private equity community and can assist small companies by bringing additional investors into a transaction.

Turning to the purpose of my appearance here today, I would like to start with some brief background points. The SBIC program is made up of three parts:

1. **The Debenture program.** The Debenture program has been in operation since the start of the SBIC program in 1958. Since 1994 its purpose has been almost exclusively to promote debt financing (generally subordinated debt) of U.S. small businesses. The program is very simple in conception: Debenture SBICs borrow money over time at low government-guaranteed interest rates (with SBA as the guarantor) to augment their private capital (the minimum required is $5.0 million) by a ratio that generally does not exceed 2:1. The private capital and borrowed money is then available to invest in small businesses at higher rates of return (with SBA setting the maximum rates of interest that can be charged). The money borrowed by SBICs is repayable in a lump sum at the close of 10 years (the general case, although it can be repaid earlier), but interest is payable semiannually. There are currently 135 Debenture SBICs managing $5.8 billion in committed capital resources.

2. **The Bank-owned SBIC program.** Prior to the passage of the Gramm-Leach-Bliley Act (GLB) in 1999 the only way a bank could operate a venture capital or private equity fund was by obtaining an SBIC license. This led to the creation of many large bank-owned SBICs (e.g., Chase Capital Partners) that did not use government-guaranteed funds to augment their capital (they could use their own depositors' capital at less cost), but still invested (as required by law) in SBIC program target U.S. small businesses. However, with the passage of GLB, banks are now permitted to operate private equity subsidiaries without the necessity of obtaining SBIC licenses. As a result, less than 5% of dollars now invested by all SBICs is attributable to bank-owned and operated SBICs. Some banks continue to invest funds in Debenture SBICs (generally for CRA credit), but the era of big bank-owned and operated SBICs is over. There are currently 58 bank-owned and operated SBICs managing $1.9 billion in committed capital resources.

3. **The Participating Security program.** The Participating Security program is the newest of the SBIC programs, but it is ramping down out of existence. The program was designed to promote equity investments in small companies. Started in FY 1994, it was the fastest growing of the SBIC programs through FY 2004. At that point the government stopped issuing Participating Security licenses because it was determined there was no way to continue the program as a credit subsidy program and appropriating leverage on a dollar-for-dollar basis was seen as impossible given the total dollars involved. The last government-guaranteed Participating Security leverage available will expire September 30, 2008. That unfortunate fact will leave most of the 167 remaining PS SBICs with no way to complete the business plans that had been approved by SBA in the licensing process, and many of these funds had projected to be in business through 2014.

With that background, NASBIC has submitted three legislative proposals for your consideration. The proposals are in keeping with our primary goal for the year: to improve the general view of the SBIC program among private sector capital managers and investors who might be inclined to participate in the SBIC program. Many of these individuals and institutions have been reluctant to participate because of negative publicity related to the government's decision to cut monetary support for the Participating Security program after September 30, 2008. That decision is considered unreasonable by the private sector and is contrary to legitimate expectations that can be found in the SBA-approved business plans of Participating Security SBICs that will be in business and in need of capital for several years after that date.

However, we must deal with the situation as we find it and we are pursuing our goal on two fronts. First, we have been working with SBA to improve the working relationship between SBA and the SBICs it regulates. This includes working together to find changes that might be made to SBA-promulgated regulations to eliminate unnecessary work or expense on both sides and to better align the regulations, where possible, with business norms in the private equity industry of which the SBIC program is a part. Examples of our collaboration include elimination of Debenture pre-payment penalties, changes in the calculation of management fees, elimination of time and expense related to what have been identified as unnecessary SBA pre-investment approvals, and a pending request that SBA change its current interest rate ceilings to better reflect market reality.

Our second and no less important effort relates to legislation to be considered by this Committee. In making the proposal I will discuss shortly, we decided to focus only on those issues that we believe fit within our overall goal. The proposals are not revolutionary in nature. The first two proposals are incremental changes that will simplify and improve the Debenture SBIC program. The third proposal is one last attempt to find a way to improve the lot of Participating Security SBICs that will suffer lack of investment capital following September 30, 2008, through no fault of their own.

A discussion of our specific proposals follows. I will not speak to suggested legislative language that we have already discussed with Committee staff. Rather, I will address the proposals in layman's terms that I believe will make them easier to understand.

1. **Rationalize the law concerning the maximum amount an SBIC can invest in any one portfolio company.**

   In this case I use the word rationalize in accordance with its primary definition: "to make rational."

   a. Currently, §306(a) of the Small Business Investment Act provides that no leveraged SBIC may invest more than 20% of its private capital in any one portfolio company without appealing for an exception to the Administrator. The intention of the limitation is to ensure that leveraged SBICs have diversified portfolios, thus mitigating investment risk for both private investors and the government.

   b. The problem with current law is that different leveraged SBICs plan for different ratios of leverage to private capital in their business plans approved by SBA in the licensing process. The projected ratios most often approved in the licensing process are between 1:1 and 2:1 even though the SBIA provides for as much as 3:1 in some cases. The application of a maximum investment amount based on a percentage of private capital versus a percentage of total capital to be managed by an SBIC produces inconsistent results unrelated to risk.

   c. For example, an SBIC licensed with an SBA approved business plan projecting 1:1 leverage would be allowed to invest 10% of its total projected capital—20% of private capital equals 10% of total planned capital at a 1:1 leverage ratio—in a single small business. An SBIC with an approved ratio of 2:1 would only be able to invest a maximum of 6.67% of its total capital in one small business. This inconsistency has nothing to do with risk management. All that it accomplishes, in strict application of the formula, is to force those SBICs that make use of two tiers of leverage to invest in 50% more companies than funds using one tier of leverage. The result is less capital available for any one small business; an inability to invest more capital in successful businesses to increase SBIC returns; and, at least as important, an SBIC management team that may be spread too thin to allocate adequate time to individual portfolio companies to help them achieve their growth goals. Time spent by SBIC professionals working on behalf of the companies they invest in is often called as valuable as or more so than the actual SBIC dollars invested in the company.

d. In summary, the current rule has no rational base, is counter to industry practice, and is a disincentive for many management teams that might otherwise consider applying for SBIC licensees.

To address this problem, NASBIC proposes that the current effective limitation of 10% of total capital for a fund using a 1:1 leverage ratio become the standard for SBICs at any leverage ratio. Instead of calculating the limit by reference only to private capital, the 10% investment limit would be calculated by reference to total capital (including leverage) projected by each SBIC in its business plan approved by SBA in the licensing process or as projected in any subsequent SBA-approved change to that business plan. This change in the law would apply a general portfolio management rule ("no more than 10% of capital should be invested in any one company") that is an accepted norm in the non-SBIC industry and would ensure that SBIC management teams have both the financial and time resources required to help their portfolio companies achieve their growth goals.

2. Adjust and simplify the laws related to the maximum leverage available to an SBIC

The following are NASBIC's observations on the laws related to the maximum leverage available to an SBIC or group of co-managed SBICs:

a. The maximum leverage cap for FY 2007 is $127.2 million for any one SBIC or for multiple SBICs controlled by the same management team. The cap increases automatically annually by the percentage increase in the Consumer Price Index (CPI).

b. The SBIC program benefits if successful SBIC management teams elect to remain in the program by securing additional SBIC licenses supported by new private capital when the primary investment periods of previous funds close. At that point the management team must raise another fund to secure an uninterrupted source of capital for making new investments. Often the "old" fund is winding down (with capital being returned to the SBIC through investment realizations) at the same time new investments are being made by the "new" fund.

c. The fact that the leverage cap applies to the whole family of funds can make it impossible for a large successful SBIC to operate a second or third fund due to lack of available leverage because of the leverage cap, not because of any increased risk to SBA based on poor financial performance. If that is the case the management team must raise a non-SBIC fund rather than stay in the program. Once that occurs the likelihood of that management team returning to the SBIC program is very small. We estimate there are at least eight Debenture SBICs that might be negatively impacted by current limits if they were to form another SBIC.

d. The maximum leverage problem related to multiple funds can be solved by making "transition" leverage available.

e. In addition, current law applies investment conditions on leverage above $90 million. For use of leverage up to $90 million, not less than 20% of investments must be in a subset of qualified small businesses defined as "smaller enterprises." Above that mark, 100% of investments made using leverage above $90 million must be in "smaller enterprises." As the leverage cap continues to grow the provision imposes additional "tracking" workloads on SBA and the impacted SBICs.

f. Finally, there are no special incentives related to leverage availability that might increase the number of SBICs that would focus on investments in women-owned and minority-owned small businesses.

To address all of the above points, NASBIC proposes that the law be changed as follows:

(1) Increase the leverage cap for any one fund to $150 million, but eliminate the annual CPI adjustment to that cap. This would give ample maximum leverage for several years and end automatic increases that might not be desirable under high inflation periods.

(2) Raise the leverage cap that applies to SBICs under the common control of one management team to $225 million. This change would allow second and third SBICs in compliance with SBA capital impairment regulations to naturally transition to investing out of the latest fund without having to "force" liquidations of investments in previous funds to "free up" leverage space.

(3) Provide an incentive that might lead to an increase in investments in minority- and women-owned small businesses by increasing the leverage caps in (1) and (2) above to $175 million and $250 million, respectively, for any SBIC that agrees that not less than 50% of its investments will be made in companies that, prior to the investment, are owned by either women or minorities or are located in a low-income geographic area.

(4) Change this percentage requirement related to investments in small enterprises to a flat 25% for all leveraged SBICs, regardless of whether they have more than $90 million in leverage.

The proposed changes will provide an incentive for successful SBIC management teams to remain in the program, simplify the laws related to maximum available leverage and how it is invested, and provide an economic incentive that may result in more capital being made available to small businesses owned by women and minorities. Incentives and simplicity will attract more management teams and investors to the SBIC program in the future.

3. Allow Participating Security SBICs to draw committed leverage faster.

a. Participating Security (PS) SBICs face a serious crisis. The only PS leverage available is that represented by commitments that expire at the latest by September 30, 2008.

b. At current investment rates PS SBICs will not be able to use all the PS leverage represented by their commitments before the expiration dates even though they will need capital after the expiration dates to fund investments and operations through the ends of their fund lives. The last of the PS funds will operate through 2014 at a minimum.

c. SBA estimates that the amount of PS leverage not drawn prior to the expiration dates may be as much as $1.0 billion. Without access to that capital PS funds will be unable to support the small businesses in their portfolios which require follow-on investments to sustain growth and will be unable to retain management teams to manage the portfolios. Risk of loss to private investors and SBA will grow substantially.

d. Failure to solve this problem is seen by the private sector as a breach by the government of the implicit promise to provide leverage to fund SBA-approved business plans through the fund's life provided the fund is in regulatory compliance and not in capital impairment. That perception will have a negative impact on the Debenture program as well; dissuading many who might otherwise seek to form SBICs from doing so.

e. At present, when leverage is drawn it must be supported by paid-in private capital rather than valid and SBA-approved capital commitments by private investors. This means that at a 2:1 leverage plan, $1.0 of private capital must be drawn in to support $2.0 of leverage draw.

To address this problem NASBIC proposes that PS SBICs be permitted to draw leverage based on SBA-approved private investor capital commitments rather than paid-in capital. This would allow them to use more of the leverage represented by expiring commitments while still having private investor commitments available to fund investments and operations after the expiration dates. The private sector commitments would still represent equity supporting SBA-guaranteed leverage and would still be payable to SBA in the event that a fund ran afoul of the capital impairment regulations after a leverage draw. No leverage draw would be permitted the regulations if a fund were in capital impairment prior to the proposed draw. While not a complete solution to the problems facing PS SBICs, enacting the proposed amendment might solve a fair percentage of the problem and indicate a government attempt to solve a problem not attributable to any failure by SBICs that face it.

Thank you again for the opportunity to appear before the Committee today. I hope my testimony will help you as the Committee drafts 2007 legislation for the SBIC program.

COMMENTS FOR THE RECORD

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Position Paper

Small Business Venture Capital Programs: The National Black Chamber of Commerce represents 140 affiliated chapters within the United States and has reach to over 100,000 African American business owners. From our interaction and perception we find that venture capital for small businesses within African American communities is minute with little impact. Over the years there has been a focus on radio station ownership and that has peaked and is now on a rough down swing. The little activity there is on venture capital comes in the way of outside companies moving into Black communities but not adding business capacity or job growth to the residents of the community. Gentrification is the only thing that is evident. One thing that must be proven about the upcoming New Markets Venture Capital program is that it will actually "touch" bona fide and qualified Black owned businesses (SDB or 8a certified). There are many games played and history shows us that in the end efforts have been PR campaigns that have added up to charades and no viable economic growth amongst Black businesses. We need a program and approach that will directly affect businesses owned and operated by African Americans. Excuses and "smoke and mirrors" will not matter much to our constituency.

SBA's Small Business Investment Company Program: We cannot find one SBIC that is owned or managed by an African American owned firm. If there is such we would like the SBA to identify it. In essence, this nation of multiple ethnicities has a major void in its SBA SBIC program. Black owned SBIC's don't exist and we feel this is more by design than coincidence. Through Black organizations such as the Urban Bankers and the National Association of Investment Companies and others the SBA should address this situation in an honest fashion and decide on diversifying its portfolio of SBIC's. The most direct way to benefit the 40 million African Americans and their communities is to provide vehicles that will link them to the mainstream economy of this nation. For a federal agency that professes to represent all communities and entities of the US business community, we must not accept a zero (0) population of Black owned SBIC's. The question is what are we going to do that will exemplify courage, leadership and fairness. We want to participate in the SBIC program. Currently, we believe there is litigation going on about this and the SBA position is one of hostility.