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106TH CONGRESS, 1st Session | HOUSE OF REPRESENTATIVES | REPORT 106–1

AMENDING SECTION 20 OF THE SMALL BUSINESS ACT AND MAKE TECHNICAL CORRECTIONS IN TITLE III OF THE SMALL BUSINESS INVESTMENT ACT

JANUARY 19, 1999.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. TALENT, from the Committee on Small Business, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.R. 68]

[Including cost estimate of the Congressional Budget Office]

The Committee on Small Business, to whom was referred the bill (H.R. 68) to amend section 20 of the Small Business Act and make technical corrections in Title III of the Small Business Investment Act, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE

The purpose of H.R. 68 is to make certain technical amendments to Title III of the Small Business Investment Act of 1958 and amend Section 20 of the Small Business Act. Title III authorizes the activities of the Small Business Investment Company program. Small Business Investment Companies (SBICs) are venture capital firms licensed by the Small Business Administration that use SBA guarantees to leverage private capital for investment in small businesses.

The technical corrections proposed by H.R. 68 will improve the flexibility of the SBIC program and allow improved access to this program by small businesses.

69–006

NEED FOR LEGISLATION

Congress revamped the SBIC program in the 103d Congress to provide for a new form of leverage geared specifically towards equity investment in small businesses. Over the ensuing years, as the new program has become established, certain deficiencies have come to light; in addition, certain statutory provisions have become obsolete.

Moreover, the nature of the SBIC industry has changed. The result is a participating securities industry made up primarily of smaller SBICs. The fact that these smaller SBICs are dominating the program points to shifting dynamics in the SBIC program. Smaller, start-up investments are more typical and, therefore, the demand for leverage has shifted to smaller individual placements.

H.R. 68 seeks to correct these deficiencies, and remove provisions that may produce confusion due to changes in law and the character of the SBIC program. First, H.R. 68 will modify the SBIC program to exclude contingent obligations from the calculation of interest in loans made by SBICs. These contingent obligations include financial tools like royalties, warrants, conversion rights and options. Many small businesses use these devices to help buy down the interest rates on their financings. Unfortunately, current law has forced SBA and the SBICs to try and include these options as part of the interest applicable for a determination of the maximum applicable interest rate. These valuations have resulted in confusion and uncertainty for all concerned and have often resulted in the loss of financing opportunities for small businesses.

Second, under H.R. 68, a provision in the Small Business Investment Act that reserves leverage for smaller SBICs will also be repealed. Changes in SBA policy regarding applications for leverage, statutory changes in the availability of commitments for SBICs, and the makeup of the industry present the possibility that that provision may, in fact, create conflicts and confusion.

Third, H.R. 68 will increase the authorization levels for the participating securities segment of the SBIC program. The authorization levels will rise from $800 million to $1 billion in fiscal year 1999, and from $900 million to $1.2 billion in fiscal year 2000. These increases are necessary to meet the rising demands for this section of the SBIC program.

Fourth, H.R. 68 modifies a test for determining the eligibility of small businesses for SBIC financing. Current statutory language does not account for small businesses organized in pass-through tax structures such as S corporations, limited liability companies, and certain partnerships. These organizations do not pay taxes at the enterprise level, but instead pass through income and the ensuing tax liabilities to their partners and shareholders. Consequently, many of these small businesses face difficulties when the income test is applied to them, and are often declared ineligible for financing they should receive.

Finally, H.R. 68 will allow the SBA greater flexibility in issuing trust certificates to finance the SBIC program's investments in small businesses. Current law allows fundings to be issued every six months or more frequently. This inhibits the ability of the SBICs and the SBA to form pools of certificates that are large

enough to generate serious investor interest. Allowing more time between fundings will permit SBA and the industry to form larger pools for sale in the market, thereby increasing investor interest and improving the interest rates for the small businesses financed.

COMMITTEE ACTION

In the 105th Congress, a hearing was held on May 12, 1998, to discuss H.R. 3412 a bill substantially similar to H.R. 68. Mr. Lee Mercer, President of the National Association of Small Business Investment Companies, testified concerning the provisions of H.R. 3412. At that hearing, Chairman Talent questioned Mr. Mercer regarding concerns that repeal of the provision reserving leverage for smaller SBICs might impair access to leverage for those firms. Mr. Mercer responded that his organization, which is composed primarily of smaller SBICs, endorsed the provision. Further, he informed the Committee that, based on industry and SBA data, 80 percent of the participating securities licensees were smaller SBICs. He also stated that demands for leverage in the participating securities were generally for small individual placements rather than any single large investments that would seriously deplete funding. Ms. Velázquez then questioned Mr. Mercer about the correction of the after-tax income test, and asked if he could supply any specific firms who had been denied eligibility due to the current test. Mr. Mercer stated that he could not name any specific firms but that he had heard of several such firms.

Ms. Velázquez, Mr. Davis and Mrs. Kelly then asked Mr. Mercer several questions concerning the SBIC industry's efforts to attract more minority and women-owned businesses for financing assistance. Mr. Mercer described a number of initiatives that his organization had started to achieve those ends. Ms. Velázquez also requested that Mr. Mercer and his organization develop and provide an outreach program for minority and women-owned businesses.

On Thursday, January 7, 1999, the Committee on Small Business held a brief hearing to consider the provisions of H.R. 68. Testifying at the hearing was Mr. Lee Mercer, President of the National Association of Small Business Investment Companies. Mr. Mercer reiterated his testimony from the 105th Congress regarding the beneficial effects that H.R. 68 would have on the SBIC program. He recognized the improvements in management that have occurred in the program over recent years and strongly recommended the corrections contained in H.R. 68. Mr. Mercer explained the five provisions and the effect they would have in detail. The hearing was in essence a reprise of the hearing held the previous year to discuss the provisions of H.R. 3412.

Mr. Hinojosa asked questions concerning the establishment of the cost of money for the SBIC program through the secondary market. Mr. Mercer explained that the cost was variable and fluctuated in correspondence with changes in the 10-year Treasury rate and the varying spread requirements of institutional investors. Ms. Napolitano also asked Mr. Mercer about the various examples of the effect and impact of the SBIC program. There being no further questions, the hearing was gaveled to a close and the Committee moved on to consideration of H.R. 68.

Immediately after the hearing, Chairman Talent called the Committee to order for the purpose of marking up and reporting H.R. 68. The bill was introduced, considered as read, and opened for amendment. No amendments were offered. Mrs. Kelly then moved to pass H.R. 68 and report it to the House. At 11:05 a.m., by a unanimous voice vote, a quorum being present, the Committee passed the bill, H.R. 68, and ordered it reported.

SECTION-BY-SECTION ANALYSIS

Section 1. Short title

Designates the bill as "The Small Business Investment Company Technical Corrections Act of 1999".

Section 2. SBIC program

(1) Paragraph (a) of section 2 modifies section 308(i)(2) of the Small Business Investment Act of 1958 to exclude contingent obligations from the calculation used to determine the maximum allowable interest rate in an SBIC financing. Contingent obligations include financial tools such as options, warrants, conversion rights and royalties. Because such devices are contingent and speculative their correct valuation has been a problem for small businesses, SBICs and the SBA.

(2) Paragraph (b) changes Section 20 of the Small Business Act to increase the authorization levels for participating securities under the SBIC program. The authorizations are increased from $800 million to $1 billion in fiscal year 1999, and from $900 million to $1.2 billion in fiscal year 2000.

(3) The first part of paragraph (c) removes subparagraph (13) of Section 303(g) of the Small Business Investment Act (15 U.S.C. 683(g)). That provision reserves 50% of participating securities leverage for Small Business Investment Companies with private capital of less than $20 million until the fourth fiscal quarter. While the Committee continues to be interested that all SBICs have access to the funding needed to complete their investments, we also recognize that this provision is no longer necessary. Only 12 of the 60 SBICs in the participating leverage program have more than $20 million in private capital, and the original concern that a few large SBICs would dominate the program has proved unfounded. It appears that most SBIC equity placements are in smaller early-stage businesses, and consequently most participating securities SBICs are established as smaller funds.

(4) The second part of paragraph (c) establishes a test for small businesses formed as tax "pass-through" entities such as S corporations or limited liability companies. Such businesses will have their small business investment eligibility determined by multiplying their net income by the combined federal and state corporate tax rate and then subtracting the result from their net income. That result will serve as the small business' estimated "after-tax income" for the purpose of determining eligibility. This removes an uncertainty in the statute that means a C corporation with as much as $9 million in pretax income could be a small business but a pass-through S corporation with $6,000,001 in income was ineligible.

(5) The final part of paragraph (c) changes Section 320 of the Small Business Investment Act to allow issuance of Small Business Administration-backed trust certificates not less than every twelve months rather than the current standard of every six months. SBA would retain the discretion to issue guarantees and trust certificates at shorter intervals if appropriate. The chance will give SBA increased flexibility in negotiating the terms and costs associated with the placement of certificates, either by contract or public offering. This will ultimately benefit the small business seeking financing since the rates sought by SBICs are reflected in the rates charged to small businesses.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, January 13, 1999.

Hon. JAMES M. TALENT,
Chairman, Committee on Small Business,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 68, the Small Business Investment Company Technical Corrections Act of 1999.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Mark Hadley.

Sincerely,

JAMES L. BLUM
(For June E. O'Neill, Director).

Enclosure.

H.R. 68—Small Business Investment Company Technical Corrections Act of 1999

Summary: H.R. 68 would make a number of technical corrections to the Small Business Investment Act of 1958. It would eliminate a provision in current law that reserves funds for smaller Small Business Investment Companies (SBICs) until the last quarter of the fiscal year. The bill also would allow a more accurate determination of eligibility of small businesses for SBIC programs by requiring the Small Business Administration (SBA) to measure a firm's revenues assuming that it has paid all required income taxes. (Certain corporate structures, such as "S" corporations, pass all income through to the stockholders. Other firms do not pass through income, but instead pay taxes at the corporate level). Finally H.R. 68 would give SBA more flexibility in issuing certificates that help finance SBIC activities by increasing the minimum placement period for public offerings from 6 months to 12 months.

The bill would increase the authorized level of the SBIC participating securities program in 1999 and 2000. CBO estimates that the subsidy costs of guarantees for the authorized levels would increase by about $10 million over the 1999–2004 period.

H.R. 68 would not affect direct spending or receipts; therefore, pay-as-you-go procedures do not apply. H.R. 68 contains no intergovernmental or private-sector mandates as defined in the Un-

funded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

Estimated cost to the Federal Government: For purposes of this estimate, CBO assumes that the bill will be enacted by March 31, 1999. CBO further assumes appropriation of authorized amounts, including a supplemental appropriation for increases of authorized amounts in fiscal year 1999. The estimated budgetary impact of H.R. 68 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

[By fiscal year, in millions of dollars]

	1999	2000	2001	2002	2003	2004
Authorizations of Appropriations						
SBIC Participating Securities Loans: [1]						
Estimated authorization level	4	6	0	0	0	0
Estimated outlays	1	6	2	([2])	0	0

[1] Implementing H.R. 68 also would increase SBA's costs for administering loans, but CBO estimates that the changes in administrative expenses would be less than $500,000 a year.

[2] Less than $500,000.

The Federal Credit Reform Act of 1990 requires appropriation of the subsidy costs and administrative costs for credit programs. The subsidy cost is the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present-value basis and excluding administrative costs.

H.R. 68 would increase the authorized program level of the SBIC participating securities program from $800 million to $1 billion in 1999 and from $900 million to $1.2 billion in 2000. Based on information from the SBA and on historical data for this program, CBO estimates that the subsidy costs of guarantees for the authorized levels would increase by $10 million over the 1999–2004 period. CBO estimates that this provision would not significantly increase the administrative costs of the agency.

Pay-as-you-go considerations: None.

Intergovernmental and private-sector impact: H.R. 68 contains no intergovernmental or private-sector mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.

Estimate prepared by: Mark Hadley.

Estimate approved by: Paul N. Van de Water, Assistant Director for Budget Analysis.

COMMITTEE ESTIMATE OF COSTS

Pursuant to the Congressional Budget Act of 1974, the Committee estimates that the amendments to Small Business Administration authorization levels in H.R. 68 will increase appropriations by no more than $10 million over the next five fiscal years, if fully funded. Furthermore, pursuant to clause 3(d)(2)(A) of rule XIII of the Rules of the House of Representatives, the Committee estimates that implementation of H.R. 68 will not significantly increase administrative costs. This concurs with the estimate of the Congressional Budget Office.

OVERSIGHT FINDINGS

In accordance with clause 4(c)(2) of rule X of the Rules of the House of Representatives, the Committee states that no oversight findings or recommendations have been made by the Committee on Government Reform with respect to the subject matter contained in H.R. 68.

In accordance with clause 2(b)(1) of rule X of the Rules of the House of Representatives, the oversight findings and recommendations of the Committee on Small Business with respect to the subject matter contained in H.R. 68 are incorporated into the descriptive portions of this report.

STATEMENT OF CONSTITUTIONAL AUTHORITY

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds the authority for this legislation in Article I, Section 8, Clause 18 of the Constitution of the United States.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SMALL BUSINESS INVESTMENT ACT OF 1958

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TITLE III—SMALL BUSINESS INVESTMENT COMPANIES

* * * * * * *

BORROWING POWER

SEC. 303. (a) * * *

* * * * * * *

(g) In order to encourage small business investment companies to provide equity capital to small businesses, the Administration is authorized to guarantee the payment of the redemption price and prioritized payments on participating securities issued by such companies which are licensed pursuant to section 301(c) of this Act, and a trust or a pool acting on behalf of the Administration is authorized to purchase such securities. Such guarantees and purchases shall be made on such terms and conditions as the Administration shall establish by regulation. For purposes of this section, (A) the term "participating securities" includes preferred stock, a preferred limited partnership interest or a similar instrument, including debentures under the terms of which interest is payable only to the extent of earnings and (B) the term "prioritized payments" includes dividends on stock, interest on qualifying debentures, or priority returns on preferred limited partnership interests which are paid only to the extent of earnings. Participating securities guaranteed under this subsection shall be subject to the follow-

ing restrictions and limitations, in addition to such other restrictions and limitations as the Administration may determine:

(1) * * *

* * * * * * *

[(13) PARTICIPATING SECURITIES FOR SMALLER SMALL BUSINESS INVESTMENT COMPANIES.—

[(A) IN GENERAL.—Subject to the provisions of subparagraph (B), of the amount of the annual program level of participating securities approved in appropriations Acts, 50 percent shall be reserved for funding small business investment companies with private capital of not more than $20,000,000.

[(B) EXCEPTION.—During the last quarter of each fiscal year, if the Administrator determines that there is a lack of qualified applicants with private capital of not more than $20,000,000, the Administrator may utilize all or any part of the program level for securities reserved under subparagraph (A) for qualified applicants with private capital of more than $20,000,000.]

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MISCELLANEOUS

SEC. 308. (a) * * *

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(i)(1) The purpose of this subsection is to facilitate the orderly and necessary flow of long-term loans and equity funds from small business investment companies to small business concerns.

(2) In the case of a business loan, the small business investment company making such loan may charge interest on such loan at a rate which does not exceed the maximum rate prescribed by regulation by the Administration for loans made by any licensee (determined without regard to any State rate incorporated by such regulation). *In this paragraph, the term "interest" includes only the maximum mandatory sum, expressed in dollars or as a percentage rate, that is payable with respect to the business loan amount received by the small business concern, and does not include the value, if any, of contingent obligations, including warrants, royalty, or conversion rights, granting the small business investment company an ownership interest in the equity or increased future revenue of the small business concern receiving the business loan.*

* * * * * * *

(j) For the purposes of sections 304 and 305, in any case in which an incorporated or unincorporated business is not required by law to pay Federal income taxes at the enterprise level, but is required to pass income through to its shareholders or partners, an eligible small business or smaller enterprise may be determined by computing the after-tax income of such business by deducting from the net income an amount equal to the net income multiplied by the combined marginal Federal and State income tax rate for corporations.

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PERIODIC ISSUANCE OF GUARANTEES AND TRUST CERTIFICATES

SEC. 320. The Administration shall issue guarantees under section 303 and trust certificates under section 319 at periodic intervals of not less than every [6] *12* months and shall do so at such shorter intervals as it deems appropriate, taking into consideration the amount and number of such guarantees or trust certificates.

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SECTION 20 OF THE SMALL BUSINESS ACT

SEC. 20. (a) * * *

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(d) FISCAL YEAR 1999.—

(1) PROGRAM LEVELS.—The following program levels are authorized for fiscal year 1999:

(A) * * *

* * * * * * *

(C) For the programs authorized by title III of the Small Business Investment Act of 1958, the Administration is authorized to make—

(i) [$800,000,000] *$1,000,000,000* in purchases of participating securities; and

(ii) $700,000,000 in guarantees of debentures.

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(e) FISCAL YEAR 2000.—

(1) PROGRAM LEVELS.—The following program levels are authorized for fiscal year 2000:

(A) * * *

* * * * * * *

(C) For the programs authorized by title III of the Small Business Investment Act of 1958, the Administration is authorized to make—

(i) [$900,000,000] *$1,200,000,000* in purchases of participating securities; and

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ADDITIONAL VIEWS

As the Ranking Democratic Member of the Small Business Committee, I want to express my strong support for a piece of legislation that I am an original cosponsor of—H.R. 68, The Small Business Investment Company Technical Corrections Act of 1999. This bill will make several key improvements to the Small Business Investment Company Act and create a more efficient and effective SBIC program.

The five provisions contained in H.R. 68 include three passed by the House early last year as H.R. 3412, The Small Business Investment Company Act of 1998. As a proponent of the SBIC program, I was a cosponsor of that bill. It successfully passed the House of Representatives by a unanimous vote last summer. I was also pleased to work in conjunction with Chairman Talent to ensure that the SBIC program was fully funded in the Fiscal Year 1999 Commerce, Justice, State Appropriations. These efforts were undertaken to make the program more efficient and responsive to the needs of investors and small entrepreneurs.

There is no question that the value of Small Business Investment Companies has been felt across the country. SBICs have invested nearly $15 billion in long-term debt and equity capital to over 90,000 small businesses. Millions of jobs have been created and billions of dollars have been added to our economy. For this reason, I believe that starting the 106th Congressional Session with an SBIC-focused bill is important.

Building on the success of last year's legislation, there are five technical improvements included in H.R. 68, The Small Business Investment Company Technical Corrections Act of 1999. The first change provides greater flexibility for funding leverage, permitting the Small Business Administration (SBA) to explore the broadest range of funding mechanisms that might reduce the cost of leverage.

The next improvement establishes an assumed tax rate for small businesses formed as pass-through entities for use in determining eligibility for SBIC funding. This will increase the number of small businesses that are eligible for SBIC funding.

The third change ends the requirement that the SBA reserve 50% of participating security leverage for the first three fiscal quarters of each year for SBICs with less than $20 million in private capital. This removes an administrative burden rendered unnecessary by the commitment process. Additionally, H.R. 68 increases the authorization level for participating securities from $800 million to $1 billion for current fiscal year 1999 and $900 million to at least $1.2 billion for fiscal year 2000.

In particular, I would like to clarify the first provision which excludes royalty agreements from the cost of money calculations. The manner in which the change is drafted is meant to give SBA the

greatest flexibility possible when they promulgate regulations. Currently, SBICs may charge one maximum permissible rate of interest for straight loans—those with no contingent rights in the small business—or a lower maximum permissible rate for hybrid loans—those with contingent rights or other equity features. SBA has long struggled with how to treat the value, if any, of the contingent equity features that an SBIC receives in these hybrid loan transactions.

This proposal aims to be a powerful new tool for underserved areas in their campaign to increase access to investment capital. However, excluding royalties is not only important for underserved areas, it is key for any small businesses trying to attract SBIC financing.

During the past few years, the SBIC program has expanded into new areas. In 1997 alone, we saw several ground breaking efforts with the creation of two women owned SBICs, and the establishment of the first Hispanic owned SBIC. The corrections envisioned by H.R. 68 are part of an ongoing process that will enable us to provide more ground breaking efforts to serve small entrepreneurs.

NYDIA M. VELÁZQUEZ.

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