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PROPOSED LEGISLATIVE REMEDY FOR THE PARTICIPATING SECURITIES PROGRAM

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BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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WEDNESDAY, JULY 27, 2005

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 10:12 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo [Chairman of the Committee] presiding.

Present: Representatives Manzullo and Velazquez

Chairman MANZULLO. Good morning, and welcome to this hearing on a very important topic for small businesses around the country: access to capital.

I am sorry I was late, but it is impolite to walk out when the President is speaking. And so I followed the protocol and waited until an opportunity arose for me to leave there and come here.

In April of this year, this Committee held a hearing on the importance of the participating securities program with small businesses needing equity investment. We also learned about the equity gap that exists between angel investors and venture capitalists.

The Administrator, on more than one occasion, has given his word to help us work toward a solution. Yesterday, I, along with Mr. Ramstad of Minnesota, introduced legislation HR 3429 that would fix the problems caused by the participating securities program.

Both the SBA and industry have had ample time to consider the merits of the draft bill.

I look forward to the testimony of both witnesses regarding key aspects of the bill, such as conformity with the Credit Reform Act, and repayment of principle and interest back to the government.

I now turn to the Ranking Member for her comments. Mrs. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

In today's economy, access to capital is clearly the key to a successful small business. In particular, venture capital has become the lifeblood for entrepreneurs.

If you look back through our nation's history, when venture capital is available to small business owners, the effects are amazing. One of the main contributing factors to the economic boom of the 1990s was increased flow of venture capital.

Unfortunately, venture capital is simply not accessible to many entrepreneurs just starting out today, particularly minority business owners. That is why programs, such as the Small Business In-

vestment Company, are so important. This program has been internationally recognized, and has a proven record.

Since 1994, it has made $8.5 billion in participating securities investment, which led to the creation of over 228,000 new jobs and $39 billion in revenue.

As this Committee is well aware, the SBIC program has now been shut down for nearly nine months. Since that time, the Bush Administration has failed to provide any solution to ensure venture capital is going to small businesses. And as a result, they have been getting less and less.

Today's hearing will begin to look for a solution, with a review of a proposal that I am sure is just one of many to come. It is my hope that this hearing will steer the Administration forward into finally taking some action.

It is important today, as we look into reopening the program, we address some of the longstanding issues that have plagued the SBIC program in the past. This program has proven its effectiveness, but it has the potential to provide even more venture capital to those who need it most.

Clearly, early-stage companies and minority-owned companies who rely heavily on this program as a source of seed capital need it the most.

In the 1990s, SBIC made nearly 50 percent of their investments in start-ups. However, this dropped to 30 percent over the past two years. We must ensure there is no further decline, and that the SBICs are not limited by any burdensome barriers, so they can continue to make these investments.

Minority-owned businesses need this investment, as well. Right now they receive only 2 percent of all venture capital investment. And in 2004, only 11 percent of the total SBIC Program financing went to minority-owned firms.

For a program that was supposed to help close this gap, this is unacceptable, and something needs to change. In addition, it is important for Congress to recognize that the SBIC Program may have to operate with an appropriation.

With the volatile nature of equity capital, if we have learned anything from past failures, it is that the government cannot always get something for nothing.

First and foremost, I want to make one thing clear. Operating the program at no cost to the government is not the priority here. The goal is to have an affordable equity program for small businesses. If that means having the government match lenders and small businesses' commitments, then so be it.

We should also use this opportunity to broaden the scope of the program and the participants it attracts. An important step in doing this is ensuring that the application process is easy to navigate and inviting to users.

Historically, the licensing approval process has been a mystery to those who have to use it. In order to create more diversity among the industry and create new appeal, we must make these processes more transparent. This will guarantee that no applicants are turned away due to a difficult approval process.

The other important component is making sure this proposal is attractive to the investment community. Congress can think a pro-

posal is wonderful, but if those that us it and invest in it do not think so, all of this work will amount to nothing more than wasted time.

These investors are the foundation of the program, and are vital in ensuring capital is available to all small businesses.

In addressing these longstanding issues as we look to reopen the program, we will not just have a program for the sake of the program, but we will have one that is open, accessible, affordable, and focuses on the sectors that need it the most: minorities and start-ups.

If this country continues to rely on this nation's entrepreneurs to spur economic development and create jobs, the need for venture capital only continues to grow. That is why the need for the SBIC Participating Security Program is crucial. Small businesses need a true equity program, and most importantly, this nation relies on this source of venture capital to help small firms advance our nation's economy forward.

And that is the end of my statement, Mr. Chairman. Thank you.

Chairman MANZULLO. Thank you very much for that very thorough statement and insight into the program we all share, and that is lack of capital.

We only have one panel and three witnesses. I want to set a 10-minute clock, and not really worry about that.

Our first witness from the Administration is a statement that I know will run more than that.

[Laughter.]

Chairman MANZULLO. Well, if not—

Mr. GUZMAN-FOURNIER. Probably five minutes.

Chairman MANZULLO. Well, whatever you like. You do not have to go 10 minutes. So we look forward to the testimony of Jaime Guzman-Fournier, Associate Administrator for Investment, US Small Business Administration. I just did not want to cut you off on time.

Mr. GUZMAN-FOURNIER. All right.

Chairman MANZULLO. We look forward to testimony, and the complete statement of the witnesses and all the Members will be made part of the record.

Thank you.

STATEMENT OF MR. JAIME A. GUZMAN-FOURNIER, US SMALL BUSINESS ADMINISTRATION

Mr. GUZMAN-FOURNIER. Mr. Chairman, Ranking Member Velazquez, Members of the Committee, I appreciate the opportunity to offer testimony on the Small Business Investment Company program, and the legislative proposal that attempts to correct the serious flaws in the Participating Securities program.

In considering this proposal, we need to ensure that the failures and losses of the Participating Security program are not repeated.

We are all familiar with the current estimates that project losses of over $2.7 billion on the more than $6 billion of participating securities disbursed through Fiscal Year 2004. In reviewing the Par-

ticipating Debentures proposal, the Administration needs to ensure that these losses would not occur again.

The Administration has studied the draft proposal to create a new form of SBIC security, called Participating Debenture. As we understand this proposal, the most basic features of this debenture are: a deferred-interest debenture with accrued interest unconditionally payable by the SBIC five years after issuance, and semi-annually thereafter. Additional payments are required if the SBIC has gross receipts, as defined by statute.

The participating debenture principal would be due and payable at the end of year 10, although it could be paid earlier.

However, the proposed legislation is unclear as to whether the trust certificate holders are entitled to regularly-scheduled interest payments during the first five-year deferral period, or whether interest on the trust certificate is also deferred.

SBA is further concerned that, although the SBICs are liable for interest payments, that their ability to make these payments is still largely dependent on the success of the fund. Five years of deferred interest on millions of dollars is a large sum of money. If SBICs are unable to make their significant interest payments at year five, the SBA will be required to make the payments on their behalf, as well as liquidation procedures to purchase the trust certificate. Unfortunately, SBA may ultimately be the party making the interest payments for the first five years.

While this proposal appears to address some of the significant issues identified in our written testimony, such as ensuring that interest is unconditionally owed by the SBICs, many other important issues are still unclear.

Last week, SBA provided the Committee with a number of questions regarding the structure, funding mechanism, distribution framework, and other features of the proposed participating debentures. We also requested information explaining the priority, amount, and timing of all of the payments associated with the participating debentures, which will help us in evaluating whether it is a debt or equity security, and its potential budgetary cost.

Some examples of questions submitted include:

Requesting a comparison of Participating Securities program cash flows to the Participating Debentures program.

Requesting information as to who would issue the trust certificates—the SBA, the SBICs, or another entity—and whether SBA would advance interest payments to the trust certificate holders on behalf of the SBICs.

Clarification, by way of specific examples, on how the distribution formula would work, identifying what payments the various parties would receive from the SBICs.

Clarification as to whether SBA leverage is fixed at two tiers lifetime, or is refinanceable.

These are a few examples of some of the critical questions raised during our initial review of the draft Participating Debenture proposal. We have received a preliminary response on some of these issues from the National Association of Small Business Investment Companies, to which the Committee had forwarded our questions and we look forward to receiving a complete response, and discussing these issues with you and your staff.

As we have suggested above, experience with the Participating Securities program can provide valuable insight into the present proposal. A thorough examination of all potential effects of the proposed Participating Debentures program is warranted, so that all costs can be properly identified and assessed.

Understanding the structure of the financial terms is important to ensure that the benefits to investors and small businesses are weighted against the cost to taxpayers.

I applaud the Committee for taking the time to address this complex proposal. I and my staff at SBA look forward to working with the Committee to consider all aspects of this legislation. Such work is necessary to ensure a full examination of the feasibility of the Participating Debentures proposal.

Thank you again for the opportunity to testify, and I look forward to your questions.

[Mr. Guzman-Fournier's statement may be found in the appendix.]

Chairman MANZULLO. Thank you so much. Our next witness has just been elevated to the faculty of Harvard Business School. Josh Lerner is a Professor of Investment Banking at Harvard Business School, Director of the Entrepreneurship Working Group, and comes with a very distinguished background. He has written several books on venture capital.

Unfortunately, he could not make it, so Mike Arlinsky, Chief Clerk of the Committee, will be reading the testimony of Professor Lerner. And Mike, that is probably about the easiest degree you picked up. Is that correct? We look forward to your testimony.

STATEMENT OF MR. JOSH LERNER, HARVARD UNIVERSITY

Mr. ARLINSKY. The statement of Josh Lerner, read into the Record.

My name is Josh Lerner. I am the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, and the director of the Entrepreneurship Working Group and the Innovation Policy and the Economy Group at the National Bureau of Economic Research. I appreciate the opportunity to submit this statement to the Committee.

The Committee is to be commended for taking a careful look at the Small Business Investment Company program. The program has a storied history, and played an important role in jump-starting the venture capital industry.

At the same time, given the tremendous growth in private sector venture capital activity, it is natural to A, if the program is still needed, and B, if the reforms proposed in the proposed legislation help the program better address these challenges.

In this testimony I outline my concerns with two aspects of the proposed legislation.

First, it is important to note that the SBIC program's history provides a great example of how public venture programs can help a nation build venture-investing infrastructure for the first time.

To be sure, after the launch of the program in 1958, SBICs drew criticism for the low financial returns generated, and the fraud and

waste associated with some funds. Viewed with hindsight, however, the program takes on a different appearance.

Though few of today's significant funds began as a part of the SBIC program, the program did stipulate the proliferation of may venture-minded institutions in Silicon Valley and Massachusetts' Route 128, the nation's two major hotbeds of venture capital. These institutions included law firms and accounting groups geared specifically to the needs of entrepreneurial firms.

For example, venture economics, which originated as the SBIC Reporting Service in 1961, gradually expanded its scope to become the major source of returns data on the entire venture industry. Moreover, some of the United States' most dynamic technology companies received support from the SBIC programs in the 1960s, 1970s, and 1980s, before they went public.

But it is also important to note that the venture capital market has changed dramatically since the establishment of the SBIC program in 1958. The pool of venture capital under management today is, in inflation-adjusted terms, more than eight times the size of that of a decade ago, and many hundred times of that three decades ago.

The pace of venture capital investment, while down from the overwrought levels of the bubble years, is still 10 times greater in real terms than the rate even a dozen years ago. In the eyes of many observers, as a review of recent issues of publications from Business Week to The Private Equity Analyst will reveal, we today have too many venture funds with too much capital chasing a limited number of attractive investments.

These general observations about the market are underscored by my experience with the SBIC program participants. To be sure, many SBIC-backed funds are run by great individuals who are targeting underserved markets.

But far too many of the SBIC participants in recent years have been marginal venture funds whose investments and approaches are not really different from their peers, with one important difference: the experience of the teams and investment theses of the funds are sufficiently tenuous that they cannot raise funds from the traditional pension funds, endowments, and other limited partners, without the program's assistance. It is very hard to see how many of these groups have addressed a market failure of any type.

The emergence of a successful private venture capital industry is, thus, in many senses a tribute to the SBIC program. But at the same time, this growth raises important questions about the program. Is the SBIC program still needed today? If so, how should it be structured?

Turning now to the specifics of the legislation, I have two major concerns. The first relates to its reliance on debt instruments; the second is the lack of any mandated assessments of the program's contribution.

First, this legislation calls for the government contribution to SBICs to be in the form of debt securities. In my eyes, this seems troublesome, since it introduces inappropriate incentives and ignores global best practice.

The problem with financing venture funds with debt is that organizations that have to make debt repayments will tend to make

low-risk investments in relatively mature firms, in order to ensure that they are able to repay their obligations.

Moreover, the ownership claims issued by the government are quite different from those provided to private investors, introducing additional potential conflicts.

These incentive problems are particularly worrisome since they will push SBICs to make investments where they do not appear to be most needed. An extensive literature on capital constraints and entrepreneurship suggests that if there is a market failure in the US for funding growth companies, it is among the very small, high-risk firms.

Firms with a real business plan and revenues today are likely to be able to attract plenty of equity or debt investors. Yet the proposed design of the SBIC program is pushing funds to make investments in precisely these lower-risk categories.

The Committee should thus consider alternative program designs that address these incentive problems. One model that is being emulated around the globe today is the Israeli Yozma program.

In June, 1992, the government established Yozma Venture Capital, Ltd.—Yozma means initiative in Hebrew—a $100 million fund wholly owned by the Israeli government.

Yozma had three goals. To promote the growth of promising high-tech firms in Israel; to encourage the involvement of major international corporations in the Israeli technology sector; and to stimulate the development of a professionally-managed, private-sector venture capital industry in Israel.

Yozma, like the SBIC program, also shared the risks associated with venture capital investments. Yet it did so using a structure that was much more similar to equity, and thus avoided many of the problems delineated above.

More specifically, the legislation that created Yozma allowed the government to contribute up to $8 million to a particular venture capital fund. These laws also required the venture capitalist to match the $8 million by raising at least an equal amount of money from limited partners. Therefore, the limited fund size was $16 million.

Thus, if one of these funds tripled in value over seven years, net of fees and incentive compensation, both the limited partners' and Yozma's investment would also triple, from $8 million to $24 million.

The limited partners could then contribute additional funds to buy out Yozma's $24 million stake for about $10 million. These partners would therefore collect $38 million on the fund's $18 million overall investment, turning an annual return of 17 percent into one of 25 percent.

This enhancement to returns was accomplished without exposure to the risks and the potential distortion of behavior that would have occurred if the Israeli government made loans to the venture fund.

My second major concern with the legislation is a lack of a mandate to carefully evaluate how the SBIC program is working, and whether it is still needed. As noted above, the venture capital has changed dramatically in recent decades, raising questions as to the role that the SBIC program plays today.

There is a real need to evaluate the SBIC program on a periodic basis. This should be a rigorous and dispassionate analysis of the program's success to date. The evaluation should also consider the overall venture capital climate, and whether the economic rationales that originally justified the program's creation still apply.

It is interesting to note that in recognition of the success of the Yozma program, the Israeli government privatized its stake in the fund in 1998, declaring the goals of the program met.

In short, the SBIC program has historically played a critical role in encouraging the development of the American venture capital industry. Given the changes in the private venture capital industry, it is reasonable to ask whether the program is still needed; and if so, what structure would be optimal.

I believe that the reliance on debt securities and the lack of a mandate for formal evaluations of the program in the proposed legislation both raise serious issues.

[Mr. Lerner's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you, Professor. We look forward to grilling you with very difficult questions.

I was just kidding, Mike. The next witness is Lee W. Mercer, who is with the National Association of Small Business Investment Companies.

Mr. Mercer, we look forward to your testimony. You can take the liberty, if you want, to incorporate your testimony into the two questions or two concerns that were raised in the written statement of Mr. Lerner.

We look forward to your testimony.

STATEMENT OF MR. LEE W. MERCER, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. MERCER. Thank you, Mr. Chairman, Ms. Velazquez, and Members of the Committee. And I will probably address some of Professor Lerner's statements later on. I will go through a little bit of my testimony first.

And I will start by saying that in April, expert witnesses, perhaps not Professor Lerner, but other expert witnesses, and company CEOs confirmed the failure to agree on a new structure to replace the Participating Security program will have a significant negative impact on equity capital available to US small businesses. They confirmed the gap that is filled by the program.

It will continue the break in the pipeline of new funds that we are experiencing this year. If new funds are not being formed every year, the capital available to small businesses will dry up quickly.

H.R. 3429 provides a structure that can solve at least a large part of the problem. Perhaps, as Professor Lerner has said, not all of the problem, but a large part of the problem. And we urge the Committee to work for its enactment in a final form later this year.

H.R. 3429 meets the qualification requirements of the Credit Reform Act. We are here because the Credit Reform Act does not allow for an equity security, as Professor Lerner suggests.

It would substantially accelerate and increase the percent of returns to SBA in all funds, and make interest and principle chargeable against private capital, whether or not a fund is profitable.

In addition, SBA's share of the profits and funds that produce greater returns would be approximately 260 percent greater than SBA's share of profits in participating security funds drawing leverage at current interest rates. This would assure that SBA would enjoy substantially larger returns in those funds that can most afford to pay it.

We are confident that the proposed legislation would carry a zero subsidy rate for appropriations purposes if scored reasonably.

Now let me address some of the specifics of the legislation. As far as Federal Credit Reform Act qualification is concerned, I believe that there can be no doubt that the security created by the proposed legislation is a debt security, for the purposes of the Act.

Attached to my testimony is an opinion of counsel from the law firm of Kirkland and Ellis to that effect. We believe that that issue is behind us, one that has kept us essentially from the negotiating table, we believe, with the Administration for about a year now.

H.R. 3429 has a dramatically improved financial structure. It will dramatically improve SBA's financial position in Participating Debenture SBICs, compared to SBA's position in Participating Security SBICs. It will do that in the following ways.

First, interest on participating debentures would be payable, irrespective of the SBIC's profitability, and would be chargeable against the SBIC's private capital. That is not true in the Participating Security program, in which interest is called "prioritized payment," and is payable only to the extent of a Participating Security SBIC's earnings. It is not chargeable in any degree against the private capital of a Participating Security SBIC.

And while interest would be deferable under certain circumstances during the first five years, SBA would not have to advance that interest to the holders of securities used to finance leverage. Again, that is substantially different from the current program. And the proposed legislation makes that clear in paragraph K2B, concerning the timing of payments.

Second, in HR 3429, distribution of any gross receipts, as defined in the legislation, would be mandatory, whether or not there were realized earnings for accounting or tax purposes. This is not true in the Participating Security program, where distributions are made only from realized earnings available for distribution.

The change would result in substantially earlier distributions to SBA that would pay down interest and leverage faster than is the case in the Participating Security program. That alone is a substantial reduction in risk for the government.

Third, HR 3429 provides that accrued interest would be paid first from any distribution, as is the case in the Participating Security program. However, after payment of interest, remaining amounts to be distributed would be distributed pro rata to SBA or to the, actually to the pools issuing the leverage, and private investors, according to their interests in the SBIC, until all outstanding SBA guaranteed leverage is paid in full.

That is not true in the Participating Security program, in which SBA's share of such distributions over and above interest payments

is only about 7-1/2 percent in funds for which SBA has provided up to 50 percent of the capital.

In HR 3429, SBA's share would be 50 percent in that example, an approximately 565-percent increase in the acceleration of funds flowing to pay back leverage. At a maximum permissible leverage ration of two thirds of the fund's capital, HR 3429 would provide that SBA's share is increased by 33-1/3 percent.

Fourth, HR 3429 provides that all sums distributed to SBA over and above that required to repay accrued interest would be used to repay leverage, until leverage is paid in full. That is not the case in the Participating Security program, in which SBA books profits before reducing leverage.

The result of this anomaly is that the Participating Security program, in that program SBA has been called upon to honor its guarantee of some leveraged principle and related interest payments in funds where there were early gains, but later losses, unnecessarily increasing interest expense, and potential loss for the government.

Finally, SBA's share of the profits in the Participating Debenture SBICs would be greatly increased compared to SBA's share in typical Participating Security SBICs. This would be accomplished by a two-tier profit-sharing program.

After all interest in SBA-guaranteed leverage has been repaid, SBA would receive a base profit share of approximately 10 percent in a participating debenture fund leveraged at a two-to-one ratio. And that would continue until a fund's private investors received distributions equal to their original investment. That is about a median performance in the venture capital industry.

Thereafter, SBA would receive about 27 percent of all remaining funds of the applicable distribution.

In marked contrast, at the current 10-year Treasury Bill rate, SBA's share of all profits in a participating security fund is only about 7-1/2 percent, not the 27 percent.

The result of this increase in SBA's share would be approximately 260 percent. Maximizing SBA returns from the most profitable funds will greatly reduce risk of loss to the government.

Finally, I am heartened by the Administration's testimony, in that, as Mr. Guzman has suggested, it is an offer to sit down together with the Committee's staff to probe the intricate particulars of the structure in HR 3429. We welcome that dialogue, and look forward to moving forward to what we hope will be a successful passage of legislation this year.

As far as Professor Lerner is concerned, part of his testimony should be more applied to the April hearing about the need for the program. And he raises some questions about whether there is a need for the program.

His position does not necessarily say no. There were experts at the April hearing who took the opposing view, among them the Tuck School at Dartmouth College, in a very detailed report that the Committee has received. So I guess we are at the point where we know that experts can differ.

As to his suggestion that using debt securities to fund an equity program causes some difficulties, there is no question but that he is correct. However, the government is constrained by the Credit Reform Act if it wants to adopt a program that can operate as a

subsidy program costing the government less than 100 cents on the dollar for every program dollar to be invested.

So I think he raises questions that need to be addressed. Some of them I think have been addressed in the April hearing; others are more properly a consideration of the role of the Credit Reform Act.

Thank you very much, Mr. Chairman, Ms. Velazquez, for your attention.

[Mr. Mercer's testimony may be found in the appendix.]

Chairman MANZULLO. I think I just have a couple of questions.

Mr. Guzman, would you agree that the proposed bill conforms with the Credit Reform Act?

Mr. GUZMAN-FOURNIER. Mr. Chairman, we are still reviewing the proposal, and have not yet made a determination on that.

Chairman MANZULLO. The questions that I was going to ask really came up in the testimony of the Professor. And I have no more questions. I would then defer to Mrs. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I do have a lot of questions. And I would like to go first to Mr. Guzman. And then if you have any other questions—thank you.

Mr. Guzman, looking at your testimony, you criticized the Participating Securities program for its losses. In doing so, you suggest that these losses justified the elimination of the government's role in the sector of the capital market.

There is a need for the program, particularly one that provides equity investment to start-up companies. I say we need to make a distinction here. Just because a program costs money does not mean that it should be done away with. And there are a lot of programs that have costs associated with them, that I don't hear the Administration calling for their elimination.

So setting the current Participating Securities program aside, given that so little venture capital is going to small businesses, why, then, your testimony seemed to indicate that there is no need for an equity program?

Mr. GUZMAN-FOURNIER. I think more than the question of a need at this point, what we are talking about, what we are analyzing back at the SBA is the cost of the program. And making an assessment as to whether the cost of this program on balance merits having it at all.

Ms. VELAZQUEZ. Mr. Guzman, cost aside, do we need this type of program?

Mr. GUZMAN-FOURNIER. I guess that is the question that even experts right now are disagreeing. I mean, I do not—

Ms. VELAZQUEZ. The expert is not saying that we do not need the program. He is talking about the start-ups and minority businesses.

Mr. GUZMAN-FOURNIER. Right. Well, I think we do not, to be quite honest about it, I do not think we have enough data—

Ms. VELAZQUEZ. I think you are not going to answer my question. Maybe you will answer my next question.

What is the Administration's position on this proposal?

Mr. GUZMAN-FOURNIER. Right now our position is that we are reviewing it, because it is a complex proposal, as I am sure you know.

Ms. VELAZQUEZ. Okay. So—

Mr. GUZMAN-FOURNIER. And we have not made a determination, as I mentioned to the Chairman, about whether it meets or not credit reform.

Ms. VELAZQUEZ. Okay. Can we get a commitment that you will provide the Administration's position, whether or not you support or oppose this proposal, within the next two weeks, in writing?

Mr. GUZMAN-FOURNIER. The first question we need to resolve here is, do we have a program that meets credit reform? I think that is critical. And that determination has not been made yet.

But that determination will be made at some point. Once that determination is made, then we are offering here to continue working with the Trade Association and the Committee to see if we can come up with a proposal that, again, makes sense from a cost standpoint.

Ms. VELAZQUEZ. Mr. Guzman—

Mr. GUZMAN-FOURNIER. We are really focusing on the cost. I want to add this. Because mainly what we are seeing here, and as I look at what I am currently overseeing in this division, is we have a program that, in its cash position right now, is at negative-$1.7 billion.

And this program, it is supposed to mirror in a way what that program was intended to do. So we want to make sure that whatever we do here, we do it with caution, and with enough carefulness so that we do not run into that type of situation again.

Ms. VELAZQUEZ. But the program has been shut down now for nine months. We held a hearing here, where you participated in, two years ago. And we had experts on the industry, and we discussed the problem of the program. And yet, the Administration has not come up with any solutions, either, or any proposal.

So do we, I guess that once you decide and make an assessment, you will be submitting to us, or at least to me, your position, the Administration's position.

Mr. GUZMAN-FOURNIER. We can at some point, once we resolve the issue of the credit reform, at some point we are going to have to go into the details of the proposal.

And yes, the Administration at some point is going to have to have the position.

Chairman MANZULLO. Would the gentlelady yield?

Ms. VELAZQUEZ. Yes.

Chairman MANZULLO. You know, I am the Chairman of this Committee, and we are the Committee of jurisdiction. You were given this three weeks ago. At what point are you going to take a detailed look at this thing?

Mr. GUZMAN-FOURNIER. Well, we submitted 35 questions. That is detailed. And it took us about two weeks to develop those 35 questions. And the National Association of Small Business Investment Companies has kindly responded to some of those questions. But, as Lee and I spoke earlier, not all of them have been answered.

And particularly the most important one—

Ms. VELAZQUEZ. Reclaiming my time, Mr. Chairman, well, it does not surprise me that it is going to take forever. We passed a Women Procurement program for four years now, and you are still studying it.

Mr. GUZMAN-FOURNIER. When we have a program that is at a negative-$1.7 billion, you have—

Ms. VELAZQUEZ. Let us go to my next question.

Mr. GUZMAN-FOURNIER. —to take prudence here.

Ms. VELAZQUEZ. Each year, the issue of the low level of minority investment in the SBIC program is brought up. And each year, nothing changes.

Last year minority businesses received below 6 percent of SBIC financing. Clearly, you are doing nothing, or either what you are doing is not working.

So what do you intend to do? What is it that the Administration, what is it that the Administrator intends to do to change?

Mr. GUZMAN-FOURNIER. We have had a program for the last two and a half years of reaching out and trying to—the critical question here is, and I said it on my previous hearing here in April, is we need to look at who is out there targeting this segment of the population, this business segment. And there are people qualified to do this type of investing.

We have had a program of reaching out and trying to find who they are, and inviting them to apply. They have to go through a rigorous process, as any other individual would go. And at the end of the day, our intent is to—

Ms. VELAZQUEZ. But in the year 2000—

Mr. GUZMAN-FOURNIER. What?

Ms. VELAZQUEZ. In the year 2000, 11 percent of venture capital went to minorities. Now it is down to 6 percent. So what kind of outreach are you doing?

Mr. GUZMAN-FOURNIER. Well, here is the thing. We do not invest in, this program does not invest directly in businesses. We do it through venture capitalists that we kind of, in a sense, "hire" to do it. And we need to target that area of the hiring, and who are we licensing here, so that we have some areas that might not be covered as well these days, to be—

Ms. VELAZQUEZ. For a long time now.

Mr. GUZMAN-FOURNIER. —covered more.

Ms. VELAZQUEZ. The proposed legislation, while designed to comply under credit reform as a debt program, seeks to encourage SBICs to make equity investments. What sort of complications can arise when a debt structure is used to facilitate equity investment?

Mr. GUZMAN-FOURNIER. Well, we have two main concerns here. The proposal creates a security that is repaid on the same basis as the private equity capital. In other words, the participating debenture gets repaid at the same time as the limited partner's equity investments in an SBIC.

So we are analyzing all the features to determine whether, even though it gets repaid on a par with the equity, the participating debenture might still be a debt security. That is an important question.

Ms. VELAZQUEZ. And do you believe that the proposal will provide SBICs with the same incentive to invest in early-stage companies as the Participating Securities program did?

Mr. GUZMAN-FOURNIER. That is another good question. And because of the deferral of interest that is part of this proposal, we also need to sit down and discuss that. Because that means that

by year five, if it is a five-year deferred interest, this money is going to come due. And that is going to affect, in my view, the business plans of these funds. Because they are going to have some pressure to come up with that money at that time, and the type of investing that they would do would be affected, in my view.

Ms. VELAZQUEZ. So under this structure, do you think it will increase investment for small companies, start-ups? Or it will decrease it?

Mr. GUZMAN-FOURNIER. We are not sure about that. We are not sure about that.

Ms. VELAZQUEZ. Do you believe that SBA's proposed profit participation is structured in a manner consistent with the amount of SBA investment in the program?

Mr. GUZMAN-FOURNIER. The profit participation is almost kept at the same levels as they were in the participating program, where we put two thirds of the capital on the first tier—and I think Lee alluded to the tiers.

The first tier of the profit participation will be 10 percent coming back to the government. That is the same percent we are pretty much getting in the participating program.

Then after the private limited partners get fully repaid, we would then get an additional second tier of capital. Which again, we have brought up in the questions we sent to the Committee as another issue we have.

Ms. VELAZQUEZ. Okay. Do you believe that the proposed tax distribution for private investors could limit SBA return; and thus, make a zero-subsidy rate difficult to achieve?

Mr. GUZMAN-FOURNIER. We think that the tax distributions would most likely have a negative impact on the—negative meaning not good, or a good impact, because it gets confusing when you talk about subsidy rates. But it is not going to have a good impact on the subsidy rate.

Ms. VELAZQUEZ. So are you confident that the proposal will operate at a zero-subsidy rate over the long term?

Mr. GUZMAN-FOURNIER. We are not.

Ms. VELAZQUEZ. In your opinion, do you believe that an equity investment program designed for higher-risk start-ups require an appropriation to function over the long term?

Mr. GUZMAN-FOURNIER. This is the question about whether this should be a grant program? Is that a better rephrasing of it?

Ms. VELAZQUEZ. No. If there should be an appropriation, a fund, an allocation.

Mr. GUZMAN-FOURNIER. It would have to be analyzed, in the sense that in a grant program—here we are paying—

Ms. VELAZQUEZ. It is not a grant program.

Mr. GUZMAN-FOURNIER. Well, I am sorry. Here the venture capitalist would receive salaries out of this money. And that is a question we have.

I mean, managers here, with an appropriation in this type of environment, managers tend to get highly paid. And that is something we would need to look at.

Ms. VELAZQUEZ. This is about—

Mr. GUZMAN-FOURNIER. I do not think the government is right now involved in any way in this type of, at this level—

Ms. VELAZQUEZ. Keeping the program and the costs of the program low for the investors and the borrowers for the start-ups, so that the fees are not high.

Mr. GUZMAN-FOURNIER. Yes.

Ms. VELAZQUEZ. And we keep the fees and the fee structure low. So then we will need an appropriation coming from the government.

Mr. GUZMAN-FOURNIER. Yes. If the program does not score at zero subsidy, it would need, it would require an appropriation. The question is whether, at the end of the day, when we see the cash flows and the distributions, and all the things that are going to be coming back to repay this leverage, whether they are going to meet the zero- subsidy criteria.

Ms. VELAZQUEZ. Thank you. Mr. Mercer, just yesterday an Ernst and Young Venture One report showed that venture capital is being directed to our later-stage companies, at the highest rate in nearly four years. This confirms what our Committee's record shows; that the greatest shortage of capital is for early-stage companies.

Do you agree with that assessment?

Mr. MERCER. I think that is probably true, yes.

Ms. VELAZQUEZ. The Participating Security program's investment in start-ups has declined from 50 percent in the nineties to 30 percent today. How will the proposed legislation reverse this trend?

Mr. MERCER. I cannot truthfully say that it would reverse that trend. I don't know whether it would go any lower. But clearly, those who have said that requiring SBICs to pay interest in the fifth year would require that at least a large portion of their investments be in small companies that were later stage than start-ups is true.

I think that there would still be room for balanced funds that would do some early-stage investing, along with later-stage investing, in order to—

Ms. VELAZQUEZ. Thank you, Mr. Chairman. And I will appreciate this later on, I will come back.

Chairman MANZULLO. Absolutely. I want to turn to Mrs. Moore from the great city of Milwaukee, where I went to Marquette Law School. And then when we are completed with your questions, we will go back to Mrs. Velazquez to finish the rest of her questions.

Go ahead.

Ms. MOORE. Well, thank you, Mr. Chairman. And indeed, you had a fine education at Marquette University, where I received my undergraduate degree. You didn't know that, huh?

Chairman MANZULLO. No, I did not know that.

Ms. MOORE. Well, I have been waiting to tell you that.

[Laughter.]

Ms. MOORE. And I want to thank our Ranking Member—

Chairman MANZULLO. At least the SBIC program can take credit for bringing people together here.

Ms. MOORE. I want to thank you all for just your diligence in this area.

I guess my question is something that I want to address to both of our witnesses. And I am very pleased that you have come today.

I have heard, I guess I want to start with Mr. Guzman. I think that you have spent a lot of focus of your testimony on the costs, the initial outlays of the federal government. And you know, if there is this great reduction in risk, there is also a reduction in the productivity.

And I was reminded of a sort of statement that I had learned early on in life, that the absence of stress is death.

And what I am concerned with is that literally, some astronomical figure, like 90 percent of all of our businesses are small businesses. And if we are destroying the SBIC program, there has been absolutely no support from the President on the new markets venture capital program, which seeded these early-generation businesses.

And all of the private venture capitalists that we see outside of the SBIC have really, really do not contribute to a diversified economic landscape in the United States. Literally, over half of the venture capital funds are focused on like California and Massachusetts. They focus on high-tech programs, and a few little niche areas, as opposed to manufacturing.

I live in a state and in a city, in Milwaukee, in Wisconsin. We are like 48th out of 49 in the nation for being able to attract venture capital. And it would just kill us to have this debenture program, which favors, as our Ranking Member pointed out, favors businesses that are already launched.

And so I guess ultimately my question is, are we headed for an economic, are we being penny-wise and pound-foolish? We save a couple of dollars, we do not make the appropriations. We call for a zero risk to the federal government. We divest totally in equity investments. I mean, you know, no support for the new venture capital program, which functions in these low-income geographic areas. This debenture program that does not help newly-generated businesses. And then the private capital that we have concentrated in two states, in a very small field.

Where are we going globally?

Mr. GUZMAN-FOURNIER. On the question of new markets, I want to make sure that you know that we are keeping track of that program internally. We have it as part of our measures that we have in the Investment Division to make sure that we know, at the end of the day—I think it has probably another year or so until we see how those companies have really done.

Their investment cycle right now is at year three or four. So by year five, we are expecting to see whether those six new market SBICs, where they stand generally. So I wanted to clarify that. We are keeping track—

Ms. MOORE. I just want to stop you for a second, because that five-year benchmark, it has the same flaws and foibles I think that Mr. Mercer and our Ranking Member were trying to point out.

I mean, the whole point in venture capital is that you are supposed to be patient.

Mr. GUZMAN-FOURNIER. Right.

Ms. MOORE. You are not supposed to eat up your success by having to repay. So if five years is your benchmark, I am getting scared already. But go on.

Mr. GUZMAN-FOURNIER. Yes. I mean, it is early enough for us to start looking at results. I am not saying that at the fifth year we are going to make a final determination here, but we are going to start looking at actual results.

On your other question, I can tell you that we have a debentures program, and that program is running. We are licensing funds in that area. That program is currently meeting the needs of small businesses, and it is running at a zero cost to the government, as we speak.

And what happened with the participating program was that we saw the cash position deteriorating in the billions, which really causes concern to anybody. And you have to really look at why what the structure of that program was that caused this to happen.

And this proposal relooks at that program, and sees how can we make this structure work. But it is a complex proposal. And that is why I have come here to say that we are looking at it, and we have submitted questions, and we are communicating with the committee in terms of questions and answers right now to figure out how to move forward.

Ms. MOORE. Well, Mr. Guzman, you know, I am a person who just does not buy lottery tickets. And so I am never going to win the lottery.

And I guess, Mr. Mercer, I would ask you to pick up from, you know, on my questions. I mean, what is the break-even point for the United States' economy? If we run scared with some losses, and a billion dollars is a lot of money. If we run scared and we don't start making investments in those dynamic companies—and I am thinking of Staples, I am thinking of, you know, Starbucks, I am thinking of—

Chairman MANZULLO. Build-A-Bear.

Ms. MOORE. Build-A-Bear, you know. I am thinking of these companies that just really, you know, if we wait until they start succeeding before we are willing to invest in them, or if we start calling in their equity after five years, I am wondering where we are headed in terms of our ability to be competitive globally. Considering that 90 percent, some astronomical number of small businesses keep our boat afloat.

Mr. MERCER. I agree with what you said, and I would like to go back. In addressing your question, I would like to do a couple things.

One, HR 3429 tries to strike a balance by deferring, first of all, the legislation was restrained by the Credit Reform Act in that, for subsidy purposes, for creating a subsidy program, it had to be a debt security.

A debt security could exist with interest deferred for the full 10 years, still chargeable against capital, still a debt instrument in the eyes of the law, the tax law, the GAAP accounting rules, and I think would pass Credit Reform Act.

The longer interest is deferred, the more likely it is that those who are involved in the program can make early-stage investments. No question about it. If interest is not deferred at all, like in the current straight debenture program, that is not a program for early-stage investments.

The longer you defer the interest in a debt instrument, the more you encourage people to be able to make early-stage investments.

In terms of, to go back to Ms. Velazquez's question about is start-up capital the biggest gap in the country. In a certain sense, the overall answer to that is yes. But as experts testified in April, there are other gaps that exist, such as in manufacturing, venture capital for small manufacturing companies. That capital for those companies is generally for later-stage companies.

So there is different kinds of gaps that are at work here. And HR 3429 would be attractive to venture capitalists investing in small manufacturing companies, because those companies do have cash flows, and by the fifth year they should be able to do it.

So it is a balance. And there is no perfect answer. I am a sailor, and there is no perfect boat, you know? You just keep tinkering with the design. There is no perfect tennis racquet. Mrs. Velazquez is an adamant tennis player, and I know she knows there is no perfect tennis racquet.

Ms. MOORE. Mr. Chairman, will you indulge me just to ask the panel another question? Ms. Velazquez really embarked upon a discussion that I would like you guys to respond to.

You know, minority businesses are very, very volatile. In my home state, in my home town, I think Hispanic companies in Wisconsin are like—African-American and Hispanic companies in my town—

Chairman MANZULLO. Mrs. Moore, would you want a minute to regroup your thoughts for that question? Would that be okay? And then I have just got a very short question here, and then we can go to you, and then back to Mrs. Velazquez again.

I am going to draft a letter that Mrs. Velazquez and I will sign, that I am going to direct the SBA to come up with a legal opinion as to whether or not this is within the parameters of the Credit Reform Act. And I am going to give you a drop-dead deadline to answer that question.

And if it is not answered, I am going to have a hearing here. And you can bring your lawyer here, and OMB can bring their lawyer here, and we will have somebody else here. I want to get this thing answered.

Because I just have the gut feeling that the SBA wants to deep-six this thing, and not come to a conclusion, based upon the fact that we had given three weeks to the SBA to respond. And on Friday, this past Friday, came back with 35 questions. And those were answered over the weekend by Mr. Mercer.

Ms. VELAZQUEZ. Mr. Chairman?

Chairman MANZULLO. Yes, go ahead.

Ms. VELAZQUEZ. I would like to mention in the letter to include a response from the Administration whether or not they support or oppose this legislation, the proposed—

Chairman MANZULLO. We can do that. That would be fine.

And the other question is, how many attorneys at the SBA are working on this issue?

Mr. GUZMAN-FOURNIER. How many attorneys?

Chairman MANZULLO. Yes.

Mr. GUZMAN-FOURNIER. Not many.

Chairman MANZULLO. Well, how many?

Mr. GUZMAN-FOURNIER. Do you need a number?

Chairman MANZULLO. Yes, I need to know. I mean, I want an answer to this.

Mr. GUZMAN-FOURNIER. I tell you, my staff is leading this, the Investment Division. It is not being led by attorneys.

The proposal has, obviously, legal ramifications—

Chairman MANZULLO. That is correct.

Mr. GUZMAN-FOURNIER. —and they are looking at those, because we are not legal experts.

Chairman MANZULLO. Right.

Mr. GUZMAN-FOURNIER. But the way we work is, the Investment Division leads, in terms of the policy analysis. And we have lawyers that assist us on the legal side of it. Which is like I think any other Committee works.

Chairman MANZULLO. Sure. Okay, Mrs. Velazquez.

Ms. VELAZQUEZ. I gather that not too many, Mr. Guzman, since the budget has been cut by almost 50 percent. You can't have that many. Yes, sure.

Chairman MANZULLO. Ms. Moore, do you want to finish up? Go ahead.

Ms. MOORE. Thank you so much, Mr. Chairman. I have regrouped.

I represent Milwaukee, Wisconsin; it is the largest city in my district. And the city of Milwaukee, among the 50 largest metropolitan areas in terms of black-owned businesses, ranks 48th for African-American-owned businesses. And, sorry about this, 49th for Hispanic-owned firms.

So by definition, if there were any venture capitalists that were going to help Hispanic- and African-American-owned businesses, they would, by definition, be start-ups.

And so to the extent—I mentioned the new market venture capital program, which, you know, the Administration rescinded the funding for any new projects for that program. And then this proposed debenture program is more geared toward medium-size already-generated businesses.

What commitment does the federal government have to helping minority-owned businesses, when you are scaling back and destroying those programs that have the potential to enable, to build the capacity for those businesses?

And we have got 59-percent unemployment rate among African-American men and men of color. So to the extent that we don't have businesses generating, those minority, you know, there is a correlation between the unemployment. This is a real crisis. This is why I am here.

They elected me to bring some resources to town. And what can I tell them that the Administration is doing specifically to help minority unemployment, ultimately?

Thank you, Mr. Chairman.

Mr. GUZMAN-FOURNIER. Well, I would go back to the programs that SBA has and its ability to—

Ms. MOORE. You rescinded the funding for the New Markets program.

Mr. GUZMAN-FOURNIER. Right. No—

Ms. MOORE. So there is no new round of funding for any Latino business in Milwaukee, under that program.

Mr. GUZMAN-FOURNIER. No, but we do have folks that are serving Latino communities within the regular, traditional SBIC under both the Participating and the Debentures program.

But going back to your question, we do have other access to capital at the agency. And we are proud of our record. And I know some people might disagree, but we are very proud of our record in terms of the loan programs in this agency since this Administration took over.

We have increased the number of loans going into these segments of the population that you mentioned. And there has been a concerted effort within the agency to look at this area.

So we are proud. I can tell you personally that I am committed, also, within the SBIC structure, to look at this area. And I have been—

Ms. VELAZQUEZ. Would the gentlelady—

Mr. GUZMAN-FOURNIER. —committed for the last two and a half years.

Ms. VELAZQUEZ. —yield to me? What programs? Prime, Business Link. Every single program that has been crafted and designed to help low-income minority businesses has been zeroed out, or their funding cut. So what programs?

Chairman MANZULLO. Ms. Moore, could I ask you a question?

Ms. MOORE. Yes, sir.

Chairman MANZULLO. Could you give me that statistic again, and try to explain that?

Ms. MOORE. The top 50 cities—

Chairman MANZULLO. You mean in terms of population.

Ms. MOORE. The largest metropolitan areas in terms of black- and Hispanic-owned firms, according to the Center for Economic Development at the University of Wisconsin, Milwaukee, Milwaukee ranks 48th among the 50 largest metropolitan areas for black-owned businesses—I have got a friend who went to Marquette who is an engineer thinking about just moving out of Milwaukee—and 49th for Hispanic-owned businesses.

Chairman MANZULLO. Could you quantify?

Ms. MOORE. Provide the study? Yes, sir.

Chairman MANZULLO. Is there a reason for that within Milwaukee? Milwaukee is a great city.

Ms. MOORE. Well, for one thing, you know, it had a manufacturing base. And to the extent that venture capitalists are moving away from manufacturing—we still have many small manufacturers that are trying to generate business—you know, that could be one of the explanations.

But just those data that the staff for this Committee provided is a key. That Massachusetts, California—I mean, the midwest is being ignored.

Chairman MANZULLO.

We had a situation in Rockford, Illinois, with Ingersoll Production Line—this was about 130 years ago. This is the company that actually invented the assembly line. I mean, this is what Henry Ford had used as a prototype. It was in the process of going under. And we had lost Ingersoll Cutting Tools Division to bankruptcy—

then an Israeli firm came in. Ingersoll Machine Tools eventually was sold to an Italian firm.

And here was Ingersoll Production Line, this wonderful company, and the man who had run it came out of retirement. We went to 10 joint venture capital firms and banks. No one was interested in buying it.

And so he went to Dalian which was a wholly-owned, state-owned, Chinese company, that came to Rockford, Illinois, bought this company, and has a very hands-off attitude. I mean, it allows the people in Rockford to run this. And they are making machine tools for production lines, and exporting those to China.

I mean, this is extraordinary. And the problems that we are seeing—and you can't tell investors where to put their money, because there is always a risk, including the taxpayers. Everything seems to go into high tech. And that is why you have the Massachusetts and the California experience. But our basic industries are just really hurting. Could that be one of the reasons?

Ms. MOORE. Yes, I couldn't agree with you more. I mean, as a State Senator, I focused on venture capital. And I was a little bit protectionist. I am trying to make sure that those investors would receive a 50-percent tax credit for investments in firms in Wisconsin.

Because the closest new market firm to Milwaukee, Wisconsin is in Ohio. That is like an eight-hour drive.

So when you say that they are helping, we have a strong manufacturing base. Harley Davidson—I know you have heard of Harley Davidson, a very successful company. But when they were in trouble, they were out there with a tin cup trying to get banks to help bail them out. Manufacturing.

We have J. I. Case, the farm equipment producer, headquartered right in Racine, Wisconsin, where I was born, 27 miles from Milwaukee. And eventually a foreign company purchased J. I. Case.

But we are having problems with the transitioning in our manufacturing culture. Because we still have many small tooling places, and we are being vastly ignored.

Now, to the extent that the SBA had been the primary source of venture capital for manufacturing-type companies, you are the first and last hope. So that if there is an unwillingness on the part of SBA to continue accepting that risk, we are in a lurch in Milwaukee, Wisconsin.

And I would love it, Mr. Chairman and Madame Ranking Member, if we can be involved in the letter, and some of the appendices, to demonstrate the crisis that we are in.

Mr. GUZMAN-FOURNIER. I wanted to add that for manufacturing in particular, the structure of the debenture program is suitable. So—

Ms. MOORE. For start-ups.

Mr. GUZMAN-FOURNIER. I would be interested in—manufacturing start-ups, or just manufacturing, period?

Ms. MOORE. Well, start-ups. We have some, I am thinking right now of some small companies that are making tools and small parts. And they are essentially start-ups, in terms of their generation.

And I am concerned—and they are also operating in these low-income geographic areas. Milwaukee, the city of Milwaukee qualifies. And the reason that I prioritized getting here today is because I wanted to hear how flexible this new proposal is.

And to the extent that you are so risk-averse—and if I am wrong, Mr. Mercer, please correct me—I think that you apologized almost for the program, saying that we are constrained by some prior law that has been passed. But it seems that we need to revisit that, as well. Because I don't know how flexible this new program will be in terms of helping a place like Wisconsin.

Mr. MERCER. Well, I mean, it can help. It can't solve all problems, there is no question about it.

But if you look at the Participating Security program which it would replace, about 35 percent of investments made in that program over the past several years have been in manufacturing companies.

Now, those are not all in start-up manufacturing companies. Because, as you know, manufacturing companies, even after they have been in existence for a while, often need an infusion of additional equity to build a balance sheet that will allow them to put on senior debt for expansion, and things like that.

So the structure in 3429 can encourage, and would encourage, that kind of investing.

But Ms. Velazquez is correct when she says the structure in 3429, which has only a five-year deferral rate for interest, would make it difficult for funds to focus on start-up businesses. There is no question about that. That is the balancing.

And that is why I say if the Committee wants to focus more on start-ups and still meet Credit Reform Act, then it has to consider deferring interest a little bit longer, because it is a cash-flow game.

Ms. MOORE. Right.

Mr. MERCER. That is what it is. And that is a balancing act that will impact subsidy rates and other things. And I am not here to tell you that I know what the right answer is. It really depends on how the Committee wants to focus.

Ms. MOORE. Thank you for your indulgence, Mr. Chairman. And I really, really appreciate Mr. Mercer being here.

I think often of a company in Milwaukee that was a meat manufacturer, very small, black-owned business, that got a lucrative contract with McDonald's to produce the sausage for their sausage breakfast sandwich. And they made tremendous investments, capital investments in order to be able to conduct this contract. Only to have their notes called—you know, their loans and equity investments being called too early. So that they found they didn't have the cash flow. Even though they had a lucrative contract. And it really destroyed, you know, the lucrative contract almost destroyed their business, because they couldn't keep pace, because they had to be repaying these debentures.

So that is what I am concerned about. We have got to be patient. Because, you know, I want to win this globalization thing. You know, I want my kids and grandkids to be able to work here. I don't want them to have to move to China in order to have a job.

Thank you, Mr. Chairman.

Ms. VELAZQUEZ. I would like for you to give us some background in terms of where we find ourselves, the Committee, the SBIC companies and the program, and the proposal that we have before us.

Can you provide the Committee with what NASBIC took, once they recognized the challenges that the participating securities faced? In particular, can you tell us about the Administration's role in the process?

Mr. MERCER. Well—

Ms. VELAZQUEZ. I just want to know, did you reach out to them?

Mr. MERCER. Yes.

Ms. VELAZQUEZ. Have any conversations? And what the Administration told you, in terms of coming up with solutions to deal with the challenges that you were facing?

Mr. MERCER. Well, we have asked repeatedly to be able to sit down to design a successor program to the Participating Security program, in a collaborative environment. And the Administration has said that it is not necessarily absolutely opposed to a successor program, but that it would respond to proposals; it would not participate in the process of developing the proposals.

That is why I said I was heartened by reading Mr. Guzman's testimony today, where it seemed to indicate for the first time that they might be willing to sit down with members of the Committee and their staffs, and hopefully to start to get into the intricacies of the structure. Because it is a technical area, and it is very difficult for one side to come up with a proposal that meets everybody's needs.

Ms. VELAZQUEZ. So Mr. Guzman, is his assessment correct?

Mr. GUZMAN-FOURNIER. Yes. We have said that we are willing to work with the Committee.

Ms. VELAZQUEZ. So you are going to sit down with NASBIC and discuss the proposal, and come up with solutions?

Mr. GUZMAN-FOURNIER. In a way we are already doing it. Because, you know, the Committee was offered our response to a proposal. And our response was that, as Lee just said, this is a complex legislation which requires complex analysis, which—

Ms. VELAZQUEZ. I heard that before.

Mr. GUZMAN-FOURNIER. —in our case is, it came up to 35. We weren't meaning to have 35 questions, but that is the extent of what we thought was important to—

Ms. VELAZQUEZ. That doesn't tell me much.

Mr. GUZMAN-FOURNIER. It is a technical, as Lee said, a technical proposal. So we definitely want to look into each aspect of it. But that—

Ms. VELAZQUEZ. Okay, so the Administration is willing to sit down, discuss this complex proposal, and reach whatever compromise or solution, so that we can move this thing forward.

Mr. GUZMAN-FOURNIER. At this point, we are already doing it. We are in discussions with the Committee.

Ms. VELAZQUEZ. Mr. Lee, what is your estimate of how often the SBA will receive a profit participation under your proposal?

Mr. MERCER. If, I am trying to now recall industry statistics over the past 20 years. Industry tracks funds by quartiles. So if the licensing is good, and I think SBA has improved its licensing criteria over the years, so they are picking very qualified investment pro-

fessionals, these funds should perform to industry averages. Which would mean the top three quartiles of funds are profitable. The bottom quartile of funds are not profitable.

So in three quarter of the funds, there should be at least some profit participation.

Now, what the Committee should understand is the top quartile of funds is the one that drives the biggest returns in venture capital. So the reason the proposal suggests a higher profit participation in the most successful funds is to enable SBA to take advantage of that top quartile of funds. And that, we hope, would do it.

Ms. VELAZQUEZ. Mr. Guzman, what is your assessment of that?

Mr. GUZMAN-FOURNIER. Well, this is an area where we have some concerns, in the sense that we are looking at it as a potential cross-subsidization of non-performing SBICs by high-performing SBICs.

And it is something that, again, I think in a cash flow scenario, when you see the scenario analysis, you might have a better sense of the numbers. But it is something that worries use, that Lee just mentioned.

Ms. VELAZQUEZ. Mr. Lee, can you further explain the conditions that private investors will be able to receive a distribution before the SBA is paid back?

Mr. MERCER. The first thing that would happen is that interest would be paid back before anybody gets anything. And after that, amounts distributed would be distributed pro rata. In other words, if SBA had 50 percent, had provided, the SBA had guaranteed money, because it is not a direct-funded program. But if SBA guaranteed money was 50 percent, they would get 50 percent of the distribution. If it was greater than 50 percent, they would get greater than 50 percent of the distribution.

So the repayment of debt, if you will, on the SBA-guaranteed capital, and the repayment of private investors on their equity accounts, would occur on a pro rata basis. And that, as you correctly stated in your opening statement, there has to be, in the development of any program, there has to be a balance that will keep the private investors attracted, as well as balancing the risk of the taxpayers. And that is one of those balancing—

Ms. VELAZQUEZ. But let me ask you, could private investors receive distributions ahead of SBA?

Mr. MERCER. No.

Ms. VELAZQUEZ. And my last question, Mr. Chairman. Given the role that the pension funds play and university endowments plays on financing the program, have these major investors endorsed this proposal?

Mr. MERCER. They have not taken a position on the proposal, no.

Ms. VELAZQUEZ. Well, I have some other questions that are important, and I will submit those in writing.

Mr. MERCER. One interesting note, I think, and it has been mentioned before, that you bring up pension plans. The biggest pension plan, of course, is CalPERS, a huge investment in venture capital funds.

And if you recalculate the Participating Security returns for the vintage years 1994 through 2000, and calculate what SBA would have gotten if it had been a regular limited partner, like CalPERS

was in the funds it invested in, the SBICs performed exactly the same, if not a little better, than the non-SBIC venture funds that CalPERS invested in.

So that is why I think I am confident in saying that these funds should perform to industry averages.

Ms. VELAZQUEZ. Mr. Chairman, I have another question for you.

Chairman MANZULLO. I have got another meeting at 1.

Ms. VELAZQUEZ. I would just like to know if we could have another hearing where we could have OMB and all these investors, so that they could comment.

Chairman MANZULLO. Well, we may end up with a hearing with all the lawyers here, if we don't get some answers on it. But we will take that under consideration. We obviously both have an interest in this.

You have both been very generous with your time. And this hearing is adjourned.

Mr. MERCER. Thank you, Mr. Chairman. Thank you, Ms. Velazquez.

Mr. GUZMAN-FOURNIER. Thank you.

[Whereupon, at 11:40 a.m., the Committee was adjourned.]

House Committee on Small Business

Proposed Legislative Remedy For The Participating Securities Program

July 27, 2005

Prepared Remarks of Chairman Donald Manzullo (IL-16), Chairman
U.S. House Small Business Committee

Good morning and welcome to this hearing on a very important topic for small businesses around the country – access to capital.

In April, this committee held a hearing on the importance of the participating securities program to small businesses needing equity investment. We also learned about the equity gap that exists between angel investors and venture capitalists.

The Administrator, on more than one occasion, has given his word to help us work toward a solution. Yesterday, I, along with Mr. Ramstad of Minnesota, introduced legislation, HR 3429, that would fix the problems caused by the participating securities program. Both the SBA and industry have had ample time to consider the merits of the draft bill.

I look forward to the testimony of both witnesses regarding key aspects of the bill, such as, conformity with Credit Reform and repayment of principal and interest back to the Administrator.

I now turn to the Ranking Member for her comments.

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
109th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Statement
of the
Honorable Nydia M. Velázquez, Ranking Member
House Committee on Small Business
Hearing on "The Proposed Participating Debentures Legislation"
July 27, 2005

Thank you Mr. Chairman.

In today's economy – access to capital is clearly the key to a successful small business. In particular, venture capital has become the lifeblood for entrepreneurs. If you look back through our nation's history, when venture capital is available to small business owners, the effects are amazing. One of the main contributing factors to the economic boom of the 1990s was the increased flow of venture capital.

Unfortunately, venture capital is simply not accessible to many entrepreneurs just starting out today – particularly minority business owners.

That is why programs such as the Small Business Investment Company (SBIC) are so important. This program has been internationally recognized, and has a proven track record. Since 1994, it has made $8.5 billion in participating securities investments, which led to the creation of over 228,000 jobs and $39 billion in revenue.

As this committee is well aware, the SBIC program has now been shutdown for nearly nine months. Since that time, the Bush administration has failed to provide any solution to ensure venture capital is going to small businesses – and as a result, they have been getting less and less.

Today's hearing will begin to look for a solution – with a review of a proposal that I am sure is just one of many to come. It is my hope this hearing will spur the administration forward into finally taking some action.

It is important today that as we look into reopening this program, we address some of the longstanding issues that have plagued the SBIC program in the past. This program has proven its effectiveness, but it has the potential to provide even more venture capital to those who need it most.

Clearly, early stage companies and minority owned businesses – who rely heavily on this program as a source of seed capital – need it the most.

In the 1990's, SBICs made nearly 50 percent of their investments in start-ups. However, this dropped to 30 percent over the past few years. We must ensure there is no further decline, and that SBICs are not limited by any burdensome barriers so they can continue to make these investments.

Minority owned businesses need these investments as well. Right now, they receive only 2 percent of all venture capital investment, and in 2004 only 11 percent of the total SBIC program financings went to minority-owned firms. For a program that was supposed to help close this gap – this is unacceptable, and something needs to change.

In addition, it is important for Congress to recognize that the SBIC program may have to operate with an appropriation. With the volatile nature of equity capital, if we have learned anything from past failures – it is that the government can't always get something for nothing.

First and foremost, I want to make one thing clear – operating the program at no cost to the government is not the priority here. The goal is to have an affordable equity program for small businesses. If that means having the government match lenders and small businesses commitments, then so be it.

We should also use this opportunity to broaden the scope of the program – and the participants it attracts. An important step in doing this is ensuring that the application process is easy to navigate and inviting to users. Historically, the licensing approval process has been a mystery to those that have to use it.

In order to create more diversity among the industry base, and create new appeal, we must make these processes more transparent. This will guarantee that no applicants are turned away due to a difficult approval process.

The other important component is making sure this proposal is attractive to the investment community. Congress can think a proposal is wonderful, but if those that use it and invest in it do not think so – all of this work will amount to nothing more than wasted time. These investors are the foundation of the program, and are vital in ensuring capital is available to all businesses.

In addressing these long standing issues as we look to reopen the program, we will not just have a program for the sake of the program. But we will have one that is open, accessible, affordable, and focuses on the sectors that need it the most – minorities and start-ups.

As this country continues to rely on this nation's entrepreneurs to spur economic development and create jobs, the need for venture capital only continues to grow. That is why the need for the SBIC participating securities program is crucial. Small businesses need a true equity program – and most importantly this nation relies on this source of venture capital to help small firms advance our nation's economy forward.

Testimony of
Jaime A. Guzmán-Fournier
Associate Administrator for Investment
US Small Business Administration
House Committee on Small Business
Hearing on Proposed SBIC Legislation
July 27, 2005

Mr. Chairman, Ranking Member Velázquez, Members of the Committee, I appreciate the opportunity to offer testimony on the Small Business Investment Company (SBIC) program and the legislative proposal that attempts to correct the serious flaws in the Participating Securities (PS) program. In considering this proposal, we need to ensure that the failures and losses of the PS program are not repeated.

We are all familiar with the current estimates that project losses of over $2.7 billion on the more than $6 billion of participating securities disbursed through FY 2004. As of the end of FY 2004, 29% of SBICs licensed prior to FY 2001 (41 of the 141 SBICs) that issued participating securities, had failed, while fewer than 5% (6 SBICs) had repaid all committed funds from the Federal Government. Of those that had failed, 75% (33 SBICs) were given funding between 1994 and 1998, when the economy and the venture capital industry were growing rapidly. After three years of liquidating failed SBICs, the program's current cash balance is approximately negative $1.7 billion. If present trends continue, SBA and the taxpayers stand to lose billions more.

One of the reasons for this is that a majority of SBICs issuing participating securities have not performed up to expectations from the SBA's perspective. Of the 49 SBICs that have generated a total net profit of $279 million for SBA, 4 SBICs provided for over 50% of this amount. As the statute provides an effective cap of less than 10% in profit participation, this small amount of profit participation from a very few funds must cover the losses from the larger number of underperforming funds.

Unfortunately, even a fund that has generated some profit does not necessarily pay off all of its SBA-backed participating securities. Of the SBIC funds that made distributions to the private investors greater than or equal to their investments (Paid-in Capital), less than a quarter or 6 SBICs had fully repaid their participating securities as of the end of FY 2004. This indicates a serious and fundamental problem with the participating securities funding instrument as the taxpayer will need to make up the repayment shortfall.

The Participating Securities program allows a fund to obtain government-backed funding of two times the private investors' contribution, with a term of 10 years. In the SBA's Debentures program, the SBIC is required to pay the interest associated with the government-backed funding (the debenture). In the

Participating Securities program, however, the SBA makes these interest payments and is only repaid out of the "profits" of the fund. Annual fees on outstanding leverage are also paid only out of the profits of the fund.

Therefore, if a fund is never profitable, neither interest payments nor annual fees will be repaid to the government. This is important, as there are currently several SBICs that are not profitable, but are also not financially impaired to the level where SBA can take action; SBA may ultimately lose the interest payments it has advanced on behalf of these SBICs. In some cases, an SBIC's outstanding prioritized payments (the advanced interest payments) actually exceed the participating security principal amount.

Requiring SBA to advance these prioritized payments, however, is not the only flaw in the participating security. As we have previously testified, the statutory distribution formula also has flaws that limit SBA's ability to recover taxpayer funds. SBA typically contributes 2/3 of the capital of an SBIC through the participating securities instrument but receives less than 10% of the profits, if any, of the fund. Moreover, participating securities SBICs distribute cash based on fairly complex rules; however in simple terms, the order of distribution is prioritized payments (or interest), profits, then redemption of equity capital. Under the distribution formula, profits are typically paid to private investors before redemption in full of the participating security.

Some of the other problems with the Participating Securities program, also identified in our previous testimony, include the following: 1) Optional "tax" distributions, although not required to be based on any private investor's actual tax liability, provide the SBIC the ability to provide even more of the overall distribution to the private investor at the expense of the taxpayer; 2) When SBA has less than or equal to 50% of the capital in a fund, it gets only its profit participation (typically less than 10%) and no repayment of interest or pay-down of the participating security. In essence, the distribution formula allows the SBICs to minimize distributions to the SBA, and maximize profit to the private investors.

These are not the only defects in the Participating Securities program. Another significant problem, for example, is that because cash flows on the participating securities instrument do not match the cash flows on the corresponding trust certificates, the trust certificates may be, effectively, SBA debt. It is important that SBA be only a guarantor of SBIC obligations and not an issuer of Agency debt.

In order to understand the effect of the program features on the performance of the program, the SBA looked at its PS SBIC funds on a vintage year basis. For vintage years 1994-1998, the SBA estimates that it received returns of barely half of all the capital and interest payments SBA made. Unfortunately, based on current net asset values in the funds, it is anticipated that

the SBA will neither be profitable nor break even for these better performing vintage years. This problem is related to the participating securities instrument itself.

This is why it is the Administration's position that, while the Participating Securities program has been well intentioned, the cost to taxpayers and the structure of the current program cannot be supported. In reviewing the participating debentures proposal, the Administration needs to ensure that these losses would not occur again.

Considering the current results of the Participating Securities program, there is a question as to whether the Government should be involved in venture capital outside of the current Debentures program. This is a valid question and one we should ask regardless of the performance of the PS program.

Now let me turn to the proposal before us. The Administration has studied the draft proposal to create a new form of SBIC security called participating debenture. As we understand this proposal, the most basic features of this debenture are: a deferred interest debenture with accrued interest unconditionally payable by the SBIC five years after issuance and semi-annually thereafter. Additional payments are required if the SBIC has gross receipts, as defined by statute. The participating debenture principal would be due and payable at the end of year 10, although it could be paid earlier.

However, it is unclear whether the trust certificate holders are entitled to regularly scheduled interest payments during the five year deferral period or whether interest on the trust certificate is also deferred. SBA is further concerned that although the SBICs are liable for interest payments, that their ability to make these payments is still largely dependent on the success of the fund. Five years of deferred interest on millions of dollars is a large sum of money. If SBICs are unable to make their significant interest payments at year 5, the SBA will be required to make the payments on their behalf, as well as instituting liquidation procedures to purchase the trust certificate. SBA may ultimately be the party making the interest payments for the first 5 years.

While this proposal appears to address some of the significant issues identified earlier in this testimony, such as ensuring that interest is unconditionally owed by the SBICs, many other important issues are still unclear. Last week, SBA provided the Committee with a number of questions regarding the structure, funding mechanism, distribution framework, and other features of the proposed participating debentures. We also requested information explaining the priority, amount and timing of all of the payments associated with the participating debentures, which will help us in evaluating its potential budgetary cost. Some examples of questions submitted include:

- On the topic of cash flows, we requested a comparison of Participating Securities program cash flows to the Participating Debentures program. As part of this analysis, we need an example on a year-by-year basis of three SBICs (one very successful, one moderately successful, and one unsuccessful) over a ten-plus year period issuing participating securities versus participating debentures.
- With respect to the funding mechanism, we need information as to who would issue the trust certificates (i.e. SBA, the SBICs or another entity) and whether SBA would advance interest payments to the trust certificate holders on behalf of the SBICs.
- On the important subject of distributions, we would need to clarify (by way of specific examples) how the distribution formula would work, identifying what payments the various parties (i.e. SBA, the trust certificate holder, and private investor) would receive from the SBICs and with multiple trust certificates involved, addressing both years 1-5 of the security and years 6-10.
- Is SBA leverage fixed at two tiers lifetime or is it re-financeable?

These are a few examples of some of the critical questions raised during our initial review of the draft participating debenture proposal. We have received a preliminary response on some of these issues from the National Association of Small Business Investment Companies, to which the Committee had forwarded our questions, and we look forward to receiving a complete response and discussing these issues with you and your staff.

As we have suggested above, experience with the Participating Securities program can provide valuable insight into the present proposal. A thorough examination of all potential effects of the proposed Participating Debentures program is warranted, so that all costs can be properly identified and assessed. Understanding the structure of the financial terms is important to ensure that the benefits to investors and small businesses are weighed against the cost to taxpayers.

I applaud the Committee for taking the time to address this complex proposal. I and my staff at SBA look forward to working with the Committee to consider all aspects of this legislation. Such work is necessary to ensure a full examination of the feasibility of the participating debentures proposal.

Thank you again for the opportunity to testify. I look forward to your questions.

Statement of Josh Lerner

U.S. House of Representatives
Committee on Small Business

Hearing on Proposed Legislative Remedy for the Participating Securities Program
Wednesday, July 27, 2005

My name is Josh Lerner. I am the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, and the director of the "Entrepreneurship Working Group" and the "Innovation Policy and the Economy Group" at the National Bureau of Economic Research. I appreciate the opportunity to submit this statement to the Committee.

The Committee is to be commended for taking a careful look at the Small Business Investment Company (SBIC) program. The program has a storied history, and played an important role in "jump-starting" the venture capital industry. At the same time, given the tremendous growth in private sector venture capital activity, it is natural to ask (a) if the program is still needed and (b) if the reforms proposed in the proposed legislation help the program better address these challenges. In this testimony, I outline my concerns with two aspects of the proposed legislation.

First, it is important to note that the SBIC program's history provides a great example of how public venture programs can help a nation build venture-investing infrastructure for the first time. To be sure, after the launch of the program in 1958, SBICs drew criticism for the low financial returns generated and the fraud and waste associated with some funds. Viewed with hindsight, however, the program takes on a

different appearance. Though few of today's significant funds began as a part of the SBIC program, the program did stimulate the proliferation of many venture-minded institutions in Silicon Valley and Massachusetts' Route 128—the nation's two major hotbeds of venture capital. These institutions included law firms and accounting groups geared specifically to the needs of entrepreneurial firms. For example, Venture Economics, which originated as the SBIC Reporting Service in 1961, gradually expanded its scope to become the major source of returns data on the entire venture industry. Moreover, some of the United States' most dynamic technology companies received support from the SBIC program in the 1960s, 1970s, and 1980s before they went public.

But it is also important to note that the venture capital market has changed dramatically since the establishment of the SBIC program in 1958. The pool of venture capital under management today is, in inflation-adjusted terms, more than eight times the size of that a decade ago, and many hundred times of that three decades ago. The pace of venture capital investment, while down from the overwrought levels of the "bubble years," is still ten times greater in real terms than the rate even a dozen years ago. In the eyes of many observers (as a review of recent issues of publications from *Business Week* to *The Private Equity Analyst* will reveal), we today have too many venture funds with too much capital chasing a limited number of attractive investments.

These general observations about the market are underscored by my experience with SBIC program participants. To be sure, many SBIC-backed funds are run by great individuals who are targeting underserved markets. But far too many of the SBIC

participants in recent years have been marginal venture funds whose investments and approaches are not really different from their peers, with one important difference: the experience of the teams and the investment theses of the funds are sufficiently tenuous that they cannot raise funds from the traditional pension funds, endowments, and other limited partners without the program's assistance. It is very hard to see how many of these groups have addressed a market failure of any type.

The emergence of a successful private venture capital industry is thus in many senses a tribute to the SBIC program. But at the same time, this growth raises important questions about the program. Is the SBIC program still needed today? If so, how should it be structured?

Turning now to the specifics of the legislation, I have two major concerns. The first relates to its reliance on debt instruments. The second is the lack of any mandated assessment of the program's contribution.

First, this legislation calls for the government contribution to SBICs to be in the form of debt securities. In my eyes, this seems troublesome, since it introduces inappropriate incentives and ignores global best practice. The problem with financing venture funds with debt is that organizations that have to make debt repayments will tend to make low-risk investments in relatively mature firms, in order to ensure that they are able to repay their obligations. Moreover, the ownership claims issued by the government

are quite different from those provided to private investors, introducing additional potential conflicts.

These incentive problems are particularly worrisome since they will push SBICs to make investments where they do not appear to be most needed. An extensive literature on capital constraints and entrepreneurship suggests that if there is a market failure in the U.S. for funding growth companies, it is among the very small, high-risk firms. Firms with a real business plan and revenues today are likely to be able to attract plenty of equity or debt investors. Yet the proposed design of the SBIC program is pushing funds to make investments in precisely these lower-risk categories!

The Committee should thus consider alternative program designs that address these incentive problems. One model that is being emulated around the globe today is the Israeli Yozma program. In June 1992, the government established Yozma Venture Capital Ltd. (*yozma* means "initiative" in Hebrew), a $100 million fund wholly owned by the Israeli government. Yozma had three goals:

- to promote the growth of promising high-tech firms in Israel,
- to encourage the involvement of major international corporations in the Israeli technology sector, and
- to stimulate the development of a professionally managed, private-sector venture-capital industry in Israel.

Yozma, like the SBIC program, also shared the risks associated with venture capital investments. Yet it did so using a structure that was much more similar to equity, and

thus avoided many of the problems delineated above. More specifically, the legislation that created Yozma allowed the government to contribute up to $8 million to a particular venture capital fund. These laws also required the venture capitalist to match the $8 million by raising at least an equal amount of money from limited partners. Therefore, the minimum fund size was $16 million. Thus, if one of these funds tripled in value over seven years—net of fees and incentive compensation—both the limited partners' and Yozma's investment would also triple, from $8 million to $24 million. The limited partners could then contribute additional funds to buy out Yozma's $24 million stake for about $10 million. These partners would therefore collect $38 million on the fund's $18 million overall investment, turning an annual return of 17 percent into one of 25 percent. This enhancement to returns was accomplished without exposure to the risks (and the potential distortions of behavior) that would have occurred if the Israeli government made loans to the venture funds.

My second major concern with the legislation is the lack of a mandate to carefully evaluate how the SBIC program is working and whether it is still needed. As noted above, the venture capital has changed dramatically in recent decades, raising questions as to the role that the SBIC program plays today. There is a real need to evaluate the SBIC program on a periodic basis. This should be a rigorous and dispassionate analysis of the programs' success to date. The evaluations should also consider the overall venture capital climate, and whether the economic rationales that originally justified the program's creation still apply. It is interesting to note that in recognition of the success of

the Yozma program, the Israeli government privatized its stake in the fund in 1998, declaring the goals of the program met.[1]

In short, the SBIC program has historically played a critical role in encouraging the development of the American venture capital industry. Given the changes in the private venture capital industry, it is reasonable to ask whether the program is still needed, and if so, what structure would be optimal. I believe that the reliance on debt securities and the lack of a mandate for formal evaluations of the program in the proposed legislation both raise serious issues.

[1]A smaller concern is that the fees permitted here look very high—so much so, that it is hard to see how investors could make a fair return. For instance, for a $10 million fund, the fees would be $250K (2.5% of $10M) plus $125K, or a total of 3.75%. This is extraordinarily high by private sector standards.

Appendix: Biography of the Author

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Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and Entrepreneurial Management Units. He graduated from Yale College with a Special Divisional Major that combined physics with the history of technology. He worked for several years on issues concerning technological innovation and public policy, at the Brookings Institution, for a public-private task force in Chicago, and on Capitol Hill. He then obtained a Ph.D. from Harvard's Economics Department.

Much of his research focuses on the structure and role of venture capital organizations. (This research is collected in two books, *The Venture Capital Cycle* (MIT Press, 1999 and 2004) and *The Money of Invention* (HBS Press, 2001).) He also examines policies concerning intellectual property protection, particularly patents, and their impact on growth and high-technology industries, much of which is discussed in *Innovation and Its Discontents* (Princeton University Press, 2004). He founded, raised funding for, and organizes two groups at the National Bureau of Economic Research: Entrepreneurship and Innovation Policy and the Economy. He is a member of a number of other NBER groups and serves as co-editor of their publication, *Innovation Policy and the Economy*. His work has been published in a variety of top academic journals.

In the 1993-94 academic year, he introduced an elective course for second-year MBAs on private equity finance. In recent years, "Venture Capital and Private Equity" has consistently been one of the largest elective courses at Harvard Business School. (The course materials are collected in *Venture Capital and Private Equity: A Casebook*, now in its third edition (Wiley, 2004).) He also teaches a doctoral course on entrepreneurship and organizes an annual executive course on private equity. He serves as the School's representative on Harvard University Patent, Trademark and Copyright Committee and on the Provost's Committee on Technology Transfer.

NASBIC
America's Small Business Partners

Statement
of
Lee W. Mercer

National Association
of
Small Business Investment Companies

Before The

United States House of Representatives
Committee on Small Business

Regarding

A Proposed Legislative Remedy For The Participating Securities Program

July 27, 2005

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Chairman Manzullo, Ranking Member Velázquez, and members of the Committee:

It is an honor to testify today on behalf of the National Association of Small Business Investment Companies regarding the legislative proposal that would, if enacted, create an SBIC Participating Debenture program to replace the current Participating Security program that does not meet the requirements of the Credit Reform Act and is structured in a manner that places significant risk of loss on the government. We believe the draft legislation is the legislative remedy to the problem that Administrator Barreto promised he would work with the Committee to fix during his testimony concerning SBA's FY 2006 budget and we urge the Committee to take the steps necessary to have the draft legislation enacted this year.

By way of introduction, I am President of the National Association of Small Business Investment Companies. As of July 20, 2005, there were 420 SBICs managing $24.2 billion in capital resources—$2.8 billion of that having been invested in 2,409 companies in FY'04. NASBIC represents the interests of these SBICs before the U.S. Congress and applicable federal agencies and provides other professional, educational, and meeting services for industry members.

With that introduction, I will turn to issues related to the legislation that is the subject of this hearing. I will summarize my remarks, but ask that my full testimony be included in the record.

1. **The Legislative Purpose.** The purpose of the bill is to replace the Participating Security (PS) SBIC program—under which no new licenses will be issued—with a new program designed to stimulate equity investments in U.S. small businesses. OMB and CBO have decided that the PS program does not meet the qualification requirements of the Credit Reform Act for a credit subsidy program such as the 7(a), 504, and Debenture SBIC programs because the security upon which the PS program is based is an equity security. In addition, the economic structure of the PS program is such that risk of loss to the government is too great to run the program at the desired zero subsidy rate without raising fees so high that private investors would not support the program.

2. **The Need For New Legislation.** The change is required this year. When existing capital held by remaining PS funds is invested, there will be no new money for equity SBIC investments unless Congress acts to create a program to replace the PS program—upon terms that will fix the flaws in the original structure. The requirement for implementing regulations and a licensing process as long as 12 months dictate a delay of at least 18 months between date of enactment and new SBIC investments.

   The need for the legislation was established by witnesses at the Committee's April 13, 2005 hearing. The Committee heard from three experts on the "Equity Gap" faced by U.S. small businesses and the failure of traditional venture capital funds to address that gap and from two CEO's of companies that received critical equity financing from PS SBICs. In addition, the National Venture Capital Association (NVCA) wrote to the President in September 2004 stating explicitly that non-SBIC private equity funds do not fill the gap. The following are brief quotes taken from the testimony of the experts and from NVCA's letter that underscore the case that has been made relative to the need for a program designed to stimulate equity investing in small businesses across the country:

Colin Blaydon, Director of the Center for Private Equity and Entrepreneurship and Dean Emeritus at the Tuck School of Business at Dartmouth College:

"The "Equity Gap" can be broadly defined as the lack of capital to early stage companies with these characteristics: requiring initial funding of less than $5 million; located away from the Silicon Valley, Boston, New York or Chicago areas; and focused in industry sectors other than information technology, life sciences or financial services. My team and I have reviewed over 40 business articles and academic papers describing some form of an equity gap or capital gap. In addition, a search of scholarly journals produced 64 cites to papers addressing the "equity gap." The fact that so many authors of so many business media and academic backgrounds have written about this issue is an indication as to its importance."

In the final of his report (July 2005) which has been delivered to the Committee, Dean Blaydon states:

"In summary, an equity gap exists by stage, by geography, and across industry sectors. Although relatively small compared to overall venture capital, SBIC investment patterns provide a counterbalance to this distribution. Given the well known and documented inefficiencies in the capital markets for venture investing, the SBIC participating securities program does fill some of the gaps created by those inefficiencies. The absence of SBIC funding, as made possible by the participating securities program would hurt small businesses through out the country, especially those in non-technology sectors such as manufacturing."

Susan Preston, an expert on angel investing and Entrepreneur-in-Residence with the Ewing Marion Kauffman Foundation, an internationally recognized foundation dedicated to the advancement of entrepreneurship in the United States.

"As supported by facts from MoneyTree™Survey, National Venture Capital Association, Center for Venture Research, Dow Jones Venture One and other sources, venture capital is no longer a realistic source of financing for the critical seed and start-up phases of a company's development – creating a funding gap for which entrepreneurs must seek other sources of funding. In the last 6 years, the amount invested in the seed/start-up stage by venture capitalists has decreased by nearly 90%, and the percentage of funding dollars has decreased by 72%."

Daniel O'Connell, Director of the Stanley C. Golder Center for Private Equity studies in the College of Business at the University of Illinois at Urbana-Champaign.

"So, is there still a need today for this kind of program? Absolutely. If anything, the increasing specialization of our business suggests an even greater need. From my experience, SBICs fill important pieces of the private equity matrix. They tend to be in regions under served by other sources. Because they have learned how to prosper from exits other than the public market, they are more comfortable with smaller businesses, and with businesses in industries or niches of a size that typically do not represent IPO potential."

Mark Heesen, President of the National Venture Capital Association, in his September 9, 2004 letter to the President George W. Bush:

"We have recently learned that there is now a debate within the Administration concerning the economic justification or "need" for SBA's Participating Security SBIC program. NVCA believes strongly that this program fills a void which non-SBIC venture funds are unable to fill. We request that our views be taken into consideration when you formulate the Administration's final position on this issue. The Participating Security program is a small but important part of America's overall capital structure. We urge the Administration to support continuation of the program and to work with all the program's stakeholders to secure the legislation necessary to achieve that result."

3. **Federal Credit Reform Act Qualification.** The proposed legislation would create a new debt security called a "Participating Debenture." The security would obligate the issuing SBIC to pay both interest and principal by a date certain—irrespective of profitability and from the equity of the SBIC if necessary. In contrast, the current PS program provides that interest is payable only if the SBIC is profitable and that there can be no charge against equity for unpaid interest. The new security gives SBA all rights normally enjoyed by creditors holding debt securities. The security is without doubt a debt security—whether considered in light of SBA's SBIC regulations, Generally Accepted Accounting Principles (GAAP), state law, or federal tax law. The law firm of Kirkland & Ellis has reviewed the legislation and issued its opinion that the security that would be created by the legislation is a "debt" for purposes of the Federal Credit Reform Act. A copy of that opinion is attached.

4. **The Improved Financial Structure.** The proposed legislation will dramatically improve SBA's financial position in Participating Debenture SBICs compared to SBA's position in Participating Security SBICs. It will do that in the following ways:

   a. Interest on Participating Debentures would be payable irrespective of the SBIC's profitability and would be chargeable against the SBIC's private capital. That is not true in the PS program, in which interest is called a prioritized payment, is payable only to the extent of a PS SBIC's earnings, and is not chargeable in any degree against the private capital of a PS SBIC.

   b. In the proposed legislation, distribution of any "gross receipts" as defined in the legislation would be mandatory whether or not there were realized earnings for accounting or tax purposes. That is not true in the PS program, in which distributions are made only from "Realized Earnings Available For Distribution." The change would result in substantially earlier distributions to SBA that would pay down interest and leverage faster than is the case in the PS program. That alone is a substantial reduction in risk for SBA.

   c. The proposed legislation provides that accrued interest would be paid first from any distribution, as is the case in the PS program. However, after payment of interest, remaining amounts to be distributed would be distributed pro rata to SBA and private investors according to their interests in the SBIC until all its outstanding SBA-guaranteed leverage is paid in full. That is not true in the PS program, in which SBA's share of such

distributions over and above prioritized payment are approximately 7.5% in funds for which SBA has provided up to 50% of the capital in today's interest rate environment. In the draft legislation SBA's share would be 50% in that example—an approximate 565% increase in the acceleration of funds flowing to SBA. At a maximum permissible leverage ratio of 66.67% under the proposed legislation, SBA's share of distributions in the proposed legislation would be 33.34% greater than it is in the PS program.

d. Under the provisions of the proposed legislation, all sums distributed to SBA over and above that required to pay accrued interest would be used to repay leverage until outstanding leverage has been paid in full. That is not the case in the PS program, in which SBA books "profits" before reducing leverage. The result of this anomaly is that in the PS program SBA has been called upon to honor its guarantee of some leverage principle and related prioritized payments in funds with early gains but later losses, unnecessarily increasing interest expense and potential loss for the government.

e. Finally, SBA's share of the profits in Participating Debenture SBICs would be greatly increased compared to SBA's share in typical PS SBICs. This would be accomplished by a two-tier profit sharing formula. After all interest and SBA-guaranteed leverage has been repaid, SBA would receive a base profit share of approximately 10% in a Participating Debenture fund leveraged 2:1 in a typical interest rate environment. That share would apply until the fund's private investors received distributions equal to their original investment. Thereafter, SBA would receive about 27% of all remaining funds of the applicable distribution. In marked contrast, at the current 10-Year Treasury Bill rate, SBA's share of **all** profits in a PS fund is about 7.5%. The result of this change would see SBA's share of profits in the most profitable funds increase by approximately 260%. That is important because—as venture capital industry data in general and SBA's SBIC data in particular proves—only a few very successful venture funds enjoy substantial profits. Maximizing SBA's potential in top quartile funds will minimize the potential for loss in the program.

5. **Conclusion.** The proposed legislation meets the qualification requirements of the Credit Reform Act, would substantially accelerate and increases the percent of returns to SBA in all funds, and make interest and principal chargeable against private capital whether or not a fund is profitable. In addition, SBA's share of profits in funds that produce greater returns would be approximately 260% greater than SBA's share of profits in Participating Security funds drawing leverage at current interest rates—assuring that SBA will enjoy substantially larger returns in those funds that can most afford to pay it. We are confident the proposed legislation will carry a "zero" subsidy rate for appropriations purposes if scored reasonably.

As expert witnesses and company CEO's have confirmed, failure to agree on a new structure to replace the Participating Security program will have a significant negative impact on equity capital availability to U.S. small businesses. It will continue the break in the pipeline of new funds that we are experiencing this year. If new funds are not being formed every year, the capital available to small businesses that have not already received some will dry up quickly. We give our unqualified support to the legislation and urge the Committee to move forward to see its enactment this year. Thank you for your consideration of our views.

Lee W. Mercer July 27, 2005

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June 22, 2005

SBIC Funding Corporation
666 11th St., NW
Suite 750
Washington, DC 20001
Attention: Mr. Lee W. Mercer, President

Re: Participating Debentures

Dear Mr. Mercer:

You have asked us for our opinion as to whether a guarantee by the United States Small Business Administration ("SBA") of the payment of interest and principal on a security with the terms set forth in Exhibit A attached hereto (a "Participating Debenture") would constitute a guarantee of "debt" or "equity" for purposes of the Federal Credit Reform Act of 1990 (the "Act").

Although we cannot predict with certainty the views of the courts or any of the federal administrative agencies in applying state and federal law, we are of the opinion that, based on the facts and research summarized below, in light of existing federal and state law, SBA's guarantee of the Guaranteed Obligations (as defined below) should be deemed to constitute a guarantee of "debt" for purposes of the Act.

1. Background

Under the proposed program, a small business investment company licensed by SBA (an "SBIC") could apply for a leverage commitment from SBA on which it could draw from time to time subject to various conditions set forth in SBA regulations. In connection with each draw, the SBIC would issue a Participating Debenture in exchange for short-term bank or other institutional financing. The short-term loans would be pooled semi-annually, with undivided interests in the pool sold to institutional investors and the proceeds used to repay the short-term financing.

Both the short-term loans and the securities issued by the pools would give their holders the right to receive payment of principal and stated interest (with no participation in profits) not later than on specified due dates, and earlier under certain specified conditions, and these payments under the proposed Participating Debentures (collectively, the "Guaranteed Obligations") would be guaranteed by SBA. Under the Participating Debentures issued by an

SBIC, the SBIC would be absolutely obligated, whether or not it earns any profits, to pay principal and interest mirroring the Guaranteed Obligations (with potential recourse to the SBIC's investors).

In addition, the SBIC would be obligated to pay the holder of the Participating Debenture a share in the SBIC's profits (referred to in Exhibit A as "additional interest" but referred to in this opinion as "profit participation"), but it is our understanding that the lenders will not have a right to share in the profit participation. The right to receive the profit participation payments will be stripped off when the loans are made and will be retained by SBA. The lenders will have a right to receive only the Guaranteed Obligations.

2. Discussion

The Act does not define "debt," nor does the legislative history of the Act state what the legislators meant by the words "debt obligation." [1] In principle, unlike a shareholder, the holder of a debt obligation does not legally take any risk in the success or failure of the venture. The holder of the debt, in his capacity as such, "is to be paid independently of the risk of success and gets a right to dip into capital when the payment date arrives."[2] Absent exceptional circumstances, an "unqualified obligation to pay a certain sum at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof"[3] is generally viewed as a debt obligation. The Guaranteed Obligations meet this definition.

However, in practice the distinction between debt and equity obligations may be subject to other considerations, and a substantial amount of case law, legal commentary, and administrative guidance has developed attempting to outline the salient characteristics of a debt instrument.[4] For example, the Internal Revenue Code (the "Code") sets out a non-exclusive list of five factors to be considered when making such a determination. These are: (1) "whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for adequate consideration... and to pay a fixed rate of interest"; (2) "whether there is subordination to or preference over any indebtedness of the corporation"; (3) the issuer's debt to equity ratio; (4) whether there is convertability into stock; and (5) "the relationship

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[1] See generally, Federal Credit Reform Act, Pub. L. No. 93-344 (1990) (codified at 2 U.S.C. § 661 et seq.(2005)).

[2] O.P.P. Holding Corp. v. Commissioner, 76 F.2d 11,12 (2nd Cir. 1935).

[3] Gilbert v. Commissioner, 248 F.2d 399, 402 (2nd Cir. 1957) (decision based on the Internal Revenue Code of 1935). See also, 11 U.S.C. § 101 (2005).

[4] See generally, Katherine Pratt, The Debt-Equity Distinction in a Second-Best World, 53 Vand. L. Rev. 1055 (2000) (arguing that as financial instruments evolve, the debt-equity distinction becomes less clear); David P. Hariton, The Taxation of Complex Financial Instruments, 43 Tax L. Rev. 731 (1988) (tax law distinguishes debt from equity according to risk-based ownership principles); Margaret A. Gibson, Comment: The Intractable Debt/Equity Problem: A New Structure for Analyzing Shareholder Advances, 81 Nw. U. L. Rev. 452 (1987).

between holdings of the issuer's stock and holdings of the interest in question."[5] The Guaranteed Obligations of the Participating Debenture satisfy all five factors.[6]

Some courts have used the following 11-factor test.[7] Under this test, an obligation is likely to be deemed a debt obligation to the extent that:

(1) *Name of the Instrument.* The debt is evidenced by instruments with names commonly associated with debt.
(2) *Fixed Maturity Date.* The debt is an unconditional obligation to pay with a fixed maturity date not too far removed.
(3) *Fixed Rate of Interest.* The debt has a fixed interest rate.
(4) *Rights Upon Default.* The creditor has customary creditor's rights if the debtor defaults.
(5) *No Equity Rights.* The debt is non-convertible, non-participating and non-voting.
(6) *Anticipated Ability to Repay.* The debtor has sufficient anticipated cash flow to repay the obligation.
(7) *No Identity of Interest between Shareholders and Debt Holders.* There is a substantial difference between debt holdings and stock holdings in terms of the identity of holders and their proportionate interests.
(8) *Debt to Equity Ratio.* The debtor's debt-to-equity ratio is reasonable.
(9) *No Subordination.* The debt is not subordinated to other creditors.
(10) *Holder Acts Like A Creditor.* The holder acts like a reasonable creditor, by taking reasonable steps to enforce his rights.[8]
(11) *Not Issued in the Acquisition of Basic Business Assets.* The debt is not tied to the acquisition of basic business assets (e.g., plants and machinery).

Generally, no one factor is controlling. As one legal commentator notes, these factors are "mere aids in determining if a particular instrument should be treated as debt or equity. The factors have varying degrees of relevance and no single factor or group of factors is

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[5] I.R.C. § 385(b)(5) (2005).

[6] For purposes of this analysis and the analysis below regarding the 11-factor test, we have assumed (1) that the aggregate unpaid balance of the Participating Debentures issued by an SBIC will never exceed 200% of the amount of capital invested in the SBIC by its investors net of any returns of invested capital, (2) that there will in fact be a substantial difference in the composition of the debt holders from that of the equity holders of the issuer, and (3) that the debt is not being incurred in the acquisition of basic business assets.

[7] See, e.g., Roth Steel Tube Co. v. Commissioner, 800 F.2d 625 (6th Cir. 1986) (using the eleven-factor test). See, also, Martin D. Ginsburg and Jack S. Levin, Mergers Acquisitions and Buyouts, ¶1302.3 (2004).

[8] See, Indmar Products Co., Inc. v. Commissioner, T.C.M. 2005-32 (U.S. Tax Ct. 2005) (creditor who waived the maturity date consecutively for 12 years was deemed to be the holder of an equity interest).

determinative."[9] A court will weigh these factors to see if the parties' intent matches with the economic reality of the instrument. In this analysis, courts are asked to go beyond the parties' definition of the relationship and to discern the true nature of their relationship.

The Guaranteed Obligations of the Participating Debenture meet all of these factors clearly, except Factors 5, 6 and 10. Factor 10 depends on the creditor: With respect to the Guaranteed Obligations, it will be met if SBA enforces the creditor's rights under the Participating Debentures and related rights under SBA regulations. With respect to Factor 6, *anticipated* (though not necessarily actual) cash flow should meet this test if SBA (i) licenses only SBICs with experienced management and (ii) enforces its rights under related regulations to take action even before a default has occurred and its rights under the proposed Participating Debentures to require the SBIC to draw on the unfunded investment commitments of its investors to pay the Guaranteed Obligations.

The one factor that may seem to point in the other direction in the case of the Participating Debentures is that on their face they give the holder a right to participate in the profits of the issuing SBIC. However, if principal and stated interest are legally payable under an instrument irrespective of whether the borrower earns any profit, and the instrument has most of the other characteristics of debt, the case law generally concludes that the instrument evidences debt and not an equity interest, even if the instrument also evidences additional rights to participate in equity returns.[10] In such cases, the additional payments based on net profits may constitute an equity interest, but the principal and interest which are payable under all circumstances should not constitute an equity interest absent other factors.[11] Furthermore, as pointed out above, it is our understanding that SBA will strip off the profit participation feature of the Participating Debentures (to compensate itself for guaranteeing principal and stated

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[9] Kevin M. Keyes, Fed. Tax . Fin. Instruments and Transactions ¶ 3.06 (2005) (citing similar language from Roth Steel Tub Co., supra, Estate of Mixon v. U.S., 464 F.2d 394, 402 (5th Cir. 1972), and Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790, 796 (1975), among other cases).

[10] See, e.g., CMA Consolidated, Inc. & Subsidiaries v. Commissioner, T.C.M. 2005-16 (US Tax Ct. Jan. 31, 2005) (stating that a creditor expects to be paid regardless of the success or failure of the debtor); Estate of Mixon v. U.S., supra, at 405; Flint Industries, Inc v. Commissioner, T.C.M. 2001-276 (US Tax Ct. Oct. 10, 2001).

[11] See, e.g., for federal income tax purposes, I.R.S. Gen. Couns. Mem. 36,702 (Apr. 12, 1976). In several tax cases, the IRS has ruled that, (i) if the issuer cannot afford to repay the obligation until it turns a profit or (ii) if, at the time of repayment, the holder of the instrument expects to receive a profit that is extraordinary, relative to the market for debt instruments, the instrument looks more like an equity interest than debt. (See, e.g., Indmar Products Co., Inc. v. Commissioner, T.C.M. 2005-32 (U.S. Tax Ct. 2005). With respect to clause (i), the Guaranteed Obligations are payable out of capital as well as from profits, and given the maximum 2:1 debt-to-equity ratio at the time of the initial SBA commitment to guarantee these obligations, an SBIC may suffer substantial losses and still be able to pay the Guaranteed Obligations.

interest), and the lender will be entitled to receive only the Guaranteed Obligations, which will be payable by the SBIC under all circumstances.[12]

3. Conclusion and Scope

In conclusion, although we cannot predict with certainty the view of the federal courts or the administrative agencies in applying federal and state law, it is our opinion based on the research as discussed above that SBA's guarantee of the Guaranteed Obligations should be characterized as a guarantee of "debt" for purposes of the Act, in light of current law.

It should be noted that the opinion expressed herein represents our opinion as to how the issues addressed herein would be resolved were they to be considered by a federal court, or other competent court or administrative agency, properly applying federal and state law. However, we do not guarantee the outcome of any dispute concerning the proposed Participating Debentures or the Guaranteed Obligations Further, the manner in which any particular issue would be treated in any actual controversy would depend on the facts and circumstances particular to that case, and this letter is not intended to guarantee the outcome of any such dispute.

This opinion speaks as of the date set forth above. We do not assume any obligation to provide any subsequent opinion or advice by reason of any change subsequent to that time in the law covered by our opinions or in the language of the Act, or by any other reason.

Finally, this opinion is given solely for the purpose of the SBIC Funding Corporation's evaluation of the proposed Participating Debentures and the Guaranteed Obligations therein, as set forth in Exhibit A. It is not meant for, and should not be used for, any other purpose or by any party other than the SBIC Funding Corporation.

Respectfully,

Kirkland & Ellis LLP

KIRLAND & ELLIS LLP

[12] In other words, the lender will not expect to receive a profit that is extraordinary out of the profit participation. See footnote 11, clause (ii).

EXHIBIT A

PARTICIPATING DEBENTURES
Principal Terms

1. Principal

a) Amount. The aggregate unpaid principal balance of the Participating Debentures issued by a small business investment company (the "SBIC") must not exceed 200% of that company's (hereafter, the "issuing company") the amount of capital invested in the SBIC by its investors net of any returns of invested capital.

b) Due Date. The principal balance of each Participating Debenture will be payable in full not later than the tenth anniversary of the date of issuance of that Participating Debenture.

2. Interest

a) Interest Rate. Interest on the principal balance outstanding of a Participating Debenture shall accrue on a daily basis, and unpaid accrued interest shall compound every six months from the date of issuance of that Participating Debenture, at a rate determined by the Secretary of the Treasury on the same basis as prioritized payments are currently computed on participating securities.

b) Due Dates. All unpaid interest on a Participating Debenture accruing during the first five years after its date of issuance will be due and payable in full on the fifth anniversary of that date. Interest accruing on a Participating Debenture after the fifth anniversary of its date of issuance will be due and payable semi-annually.

3. Payment Defaults

In the event of a failure of an issuing company to pay any principal or interest on a Participating Debenture when due (a "Payment Default"), the Administration, in addition to any other remedies that it may have, will be entitled to demand immediate repayment of the principal balance and immediate payment of all accrued interest on any or all outstanding Participating Debentures issued by the defaulting company.

4. Payment and Prepayment from Gross Receipts

(a) Gross Receipts. "Gross Receipts" means all cash received by an issuing company, including proceeds of the sale of securities, management or other fees, and cash representing return of invested capital, other than capital contributed by partners, the proceeds of the issuance of Participating Debentures, and money borrowed from other sources, if any. Marketable Securities that the company distributes in kind will be distributed as if they were Gross Receipts.

(b) Payment of Past Due Interest and Principal. An issuing company must use Gross

Receipts within 10 days after receipt to repay any outstanding past due interest and past due principal (whether past due by their terms or by acceleration).

(c) Mandatory Interest Prepayment. If an issuing company has no outstanding past due interest or principal, it must use Gross Receipts to prepay accrued interest. Such prepayment will be due not later than the end of the calendar quarter during which such Gross Receipts were received, provided, however, that Gross Receipts received within 15 days before the end of a calendar quarter will be deemed to have been received in the immediately following calendar quarter for purposes of this Section 4(c). Such prepayments will be applied to accrued interest on the company's Participating Debentures in the order in which such interest will become due and payable. Failure to prepay accrued interest as provided in this Section 4(c) will be deemed a Payment Default for purposes of Section 3 above.

(d) Principal Prepayment. At such time as there is no unpaid, accrued interest or past due principal outstanding on a company's Participating Debentures, the company may, subject to Section 5(a), use Gross Receipts to prepay Participating Debenture principal that is not past due.

(e) Expenses. At such time as there is no unpaid, accrued interest or past due principal outstanding on a company's Participating Debentures, the company may, subject to Section 5(a) and only to the extent otherwise permitted under applicable SBA regulations, use Gross Receipts (whenever received) to pay its expenses and other liabilities (including management fees).

(f) Other Cash. An issuing company may use cash that does not constitute Gross Receipts ("other cash") to repay or prepay principal and interest on the Participating Debentures in any amount, provided that any distribution of other cash to private investors must be accompanied by a corresponding distribution to the Administration as if such other cash constituted Gross Receipts, except for tax distributions pursuant to Section 5(b) below.

5. Distributions to Private Investors

Subject to Section 4 above, an issuing company may distribute Gross Receipts to private investors only as provided in this Section 5.

(a) SBA Regulations and State Law. The distribution must not violate SBA liquidity requirements or other applicable SBA regulations or state law requirements (e.g., for a limited partnership formed under Delaware law, Delaware RULPA § 17-607). Without limiting the generality of the foregoing, no distribution may be made to an issuing company's private investors at any time that the company is in restricted operations or liquidation by reason of capital impairment or regulatory violation.

(b) Tax Distributions. Subject to Sections 1(a), 4(b), 4(c), 5(a), and 6, as long as any principal is outstanding on any Participating Debenture, the issuing company may make a special distribution of Gross Receipts or other cash to its private investors without a corresponding distribution to the Administration in the following circumstances:

(i) The issuing company has an investment in a company (the "portfolio company") organized as a limited liability company ("LLC") or as a partnership.

(ii) The portfolio company has income which will be taxable to its members or partners.

(iii) The portfolio company makes a distribution to its members or partners in an amount equal to their assumed tax liability on the portfolio company's taxable income (a "Tax Distribution").

(iv) The issuing company is itself a partnership or an LLC, so that any portfolio company income allocated to the issuing company is reallocated to the private investors and it is they who are liable for payment of tax on that income as if it was their own income, whether or not they receive any cash in respect of that income.

In those circumstances, the issuing company may, prior to April 15 of each calendar year, distribute to its private investors up to an amount equal to the difference between (x) the estimated aggregate maximum tax liability of the private investors on the income of portfolio companies organized as LLCs or partnerships during the preceding calendar year and (y) the aggregate amount distributed to the private investors (other than pursuant to this Section 5(b)) since April 15 of the preceding calendar year, but in no event more than the aggregate amount of Tax Distributions that the issuing company received during the preceding calendar year.

(c) Other Pre-Amortization Distributions. An SBIC may not make any distributions to its private investors, whether of Gross Receipts or other property (including other cash), except as permitted under Section 5(b) above, this Section 5(c) or Section 5(d) below. As long as any Participating Debentures issued by an SBIC are outstanding, the company may distribute Gross Receipts to its private investors, subject to Sections 4(b), 4(c), and 5(a), but only if not less than a pro rata amount (based on the ratio of then outstanding leverageable capital to Participating Debenture principal) is simultaneously distributed to SBA.

(d) Post-Amortization Distributions. At such time as all Participating Debenture principal and all private capital have been repaid in full, Gross Receipts may be distributed ("Post-Amortization Distribution") as follows:

(i) to SBA, a portion of the total amount being distributed equal to 25% of the ratio of total SBA leverage previously drawn (including leverage that has been repaid) by the SBIC to total leverageable capital previously drawn by the company reduced by the weighted average interest rate on the Participating Debentures issued by the company, and the remainder to the private investors, until private investors have received total Post-Amortization Distributions in an amount equal to 100% of the total leverageable capital previously drawn from them; and

(ii) thereafter, to SBA a portion of the total amount being distributed equal to 50% of the ratio of total SBA leverage previously drawn (including leverage that has been repaid) by the SBIC to total leverageable capital previously drawn by the company reduced by the weighted average interest rate on the Participating Debentures issued by the company, and the remainder to the private investors.

(iii) Any Post-Amortization Distributions to SBA pursuant to this Section 5(d) shall be deemed to constitute additional (but not "accrued") interest.

(e) Liquidity Requirements. Notwithstanding any other provision hereof, no distribution of Gross Receipts or other cash may be made if such distribution would violate SBA liquidity requirements (e.g., 13 CFR § 107.1505) or state law restrictions (e.g., Delaware RULPA, § 17-607).

6. Liquidation

In liquidation, an issuing company may not distribute Gross Receipts or other cash to its private investors until all accrued interest and principal on the Participating Debentures have been paid in full, and the Administration will have the right to require the private investors to contribute their unfunded commitments for the purpose of repaying such accrued interest and principal.

NASBIC
America's Small Business Partners

The Impact Of The Participating Security SBIC Program

- **Through June 30, 2005, Participating Security SBICs had made $9.7 billion in equity investments in U.S. small businesses since the FY'94 program inception.**

- **Participating Security SBICs account for 55% of all SBIC investments and are a major source of seed capital in the U.S. According to SBA, SBICs provided 64% of seed capital invested by institutional investors during FY'94 – FY'02.**

- **Approximately 35% ($3.4 billion) of the $9.7 billion in Participating Security investments from FY'94 to date were made in small manufacturing companies.**

- **Participating Security SBICs were the most reliable source of equity capital for U.S. small businesses during the recession. All venture capital investments fell 83% between 2000 and 2003 according to Venture Economics. Participating Security investments during that period—a total of $5.25 billion—fell just 23%.**

- **Raising equity capital in the SBIC target range of $1.0- to $5.0 million is the most difficult for a small company to secure. The average VC "deal" size is between $7.0- and $10.0 million. The "Equity Capital Gap" is real and an impediment to small business job creation. SBICs fill that gap.**

- **Non-SBIC venture capital is concentrated in a very few states. For the period FY'94 – FY'02, companies in California and Massachusetts received 52% of all venture capital. During the same period, SBIC's invested only 29% of their capital in companies in those states.**

- **The $9.7 billion in Participating Security investments since 1994 have led to the creation of an estimated 269,000 new jobs and $46 billion in portfolio company revenue. Sixty-two percent of that growth—170,000 jobs and $29.2 billion in portfolio company revenue—occurred during the recession recovery period of from the start of FY 2001 to date.**

  (Estimate based on a 2001 National Venture Capital Association study that found that one sustainable job is created for every $36,000 in venture capital invested in a small business and every $1.00 in venture capital leads to $4.75 in portfolio company revenue.)

National Association of Small Business Investment Companies
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Lee W. Mercer July 27, 2005

Lee W. Mercer

Lee Mercer is president of the National Association of Small Business Investment Companies, having joined the association in that capacity in 1996. SBICs are government-licensed, government-regulated, but privately managed private equity firms that invest a combination of private and government-guaranteed capital in U.S. small businesses that meet size and operational requirements promulgated by the government. As of July 20, 2005, there were 420 SBICs managing $24.2 billion in capital resources—$2.8 billion of that having been invested in 2,409 companies in FY'04. NASBIC represents the interests of the SBIC industry before the U.S. Congress and applicable federal agencies and provides other professional, educational, and meeting services for industry members.

Prior to joining NASBIC, Mr. Mercer held several positions in both the private and public sectors. In the private sector, he had been a partner in a New Hampshire law firm, a senior program manager and government affairs representative for Digital Equipment Corporation, and president of two privately owned small businesses. In government, he served as legislative director and counsel for former U.S. Senator Warren Rudman (R-NH) and as deputy undersecretary of the U.S. Department of Commerce during parts of the administrations of Presidents Ronald Reagan and George H. W. Bush—first with the Export Administration and then the Technology Administration. While with Senator Rudman, Mr. Mercer was the primary manager of the legislative campaign that resulted in the creation of the Small Business Innovative Research (SBIR) program, a program that provides more than $1.0 billion per year in federal research and development contracts to small, technology-based U.S. companies. During his career, Mr. Mercer has served as a director of several private companies and as a member of several government advisory boards.

Mr. Mercer received his BA degree from Dartmouth College and JD and LLM degrees from the Boston University School of Law. He served in the U.S. Marine Corps from 1966 to 1968.

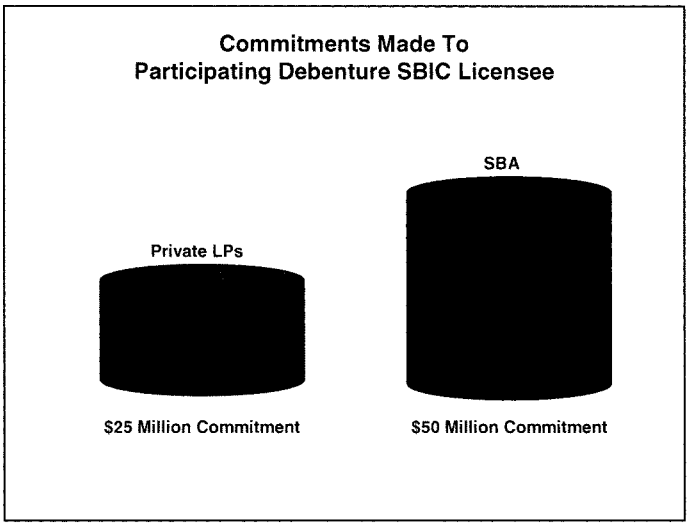
Participating Debentures

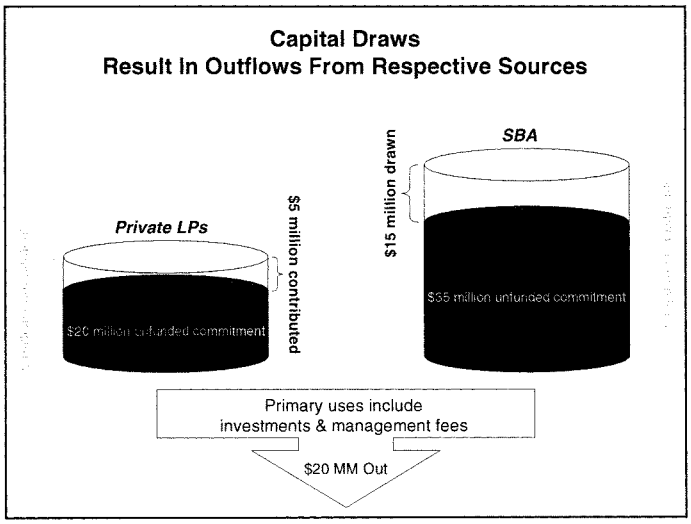
A Pictorial Representation
of
Proposed Distribution Rules

National Association of Small Business Investment Companies
July 2005

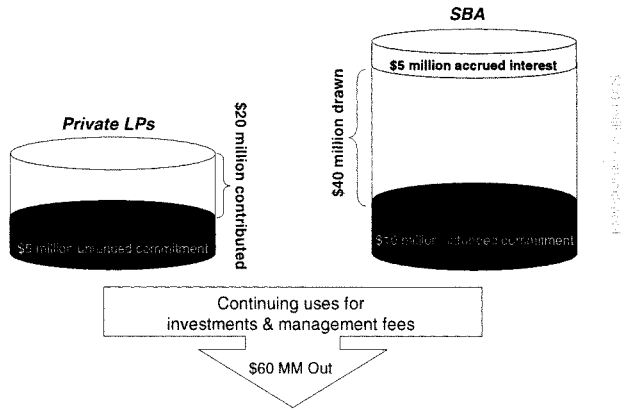
Changes Favorable to SBA vs. Old PS Program

- Distributions to SBA are required from "gross receipts" instead of "realized earnings available for distribution."
- Interest is paid regardless of fund profitability and (with leverage) is chargeable against private capital.
- After interest, SBA receives "pro rata" distributions until all leverage is repaid. At a 1:1 leverage ratio the increase is over 500%. At 2:1 it is 33%. This greatly accelerates the rate at which leverage is repaid.
- SBA's profit share is calculated in two tiers. The first is about 20% greater than the PS rate. However, SBA's total profit share in the most profitable funds is increased by approximately 260%.
- SBA cannot be disadvantaged by distribution timing.

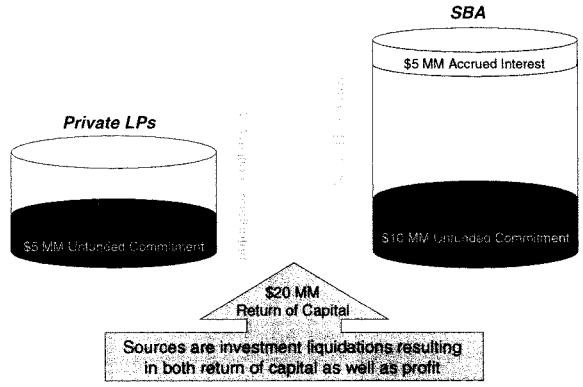

Commitments Made To
Participating Debenture SBIC Licensee
SBA
Private LPs
$25 Million Commitment
$50 Million Commitment


Capital Draws
Result In Outflows From Respective Sources
SBA
$15 million drawn
Private LPs
$5 million contributed
$35 million unfunded commitment
$20 million unfunded commitment
Primary uses include
investments & management fees
$20 MM Out

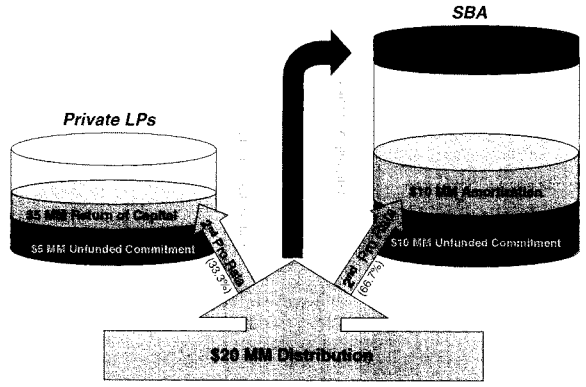
In The Early Years, Outflows Continue & Interest Accrues On The Participating Debentures. Interest Is Estimated.



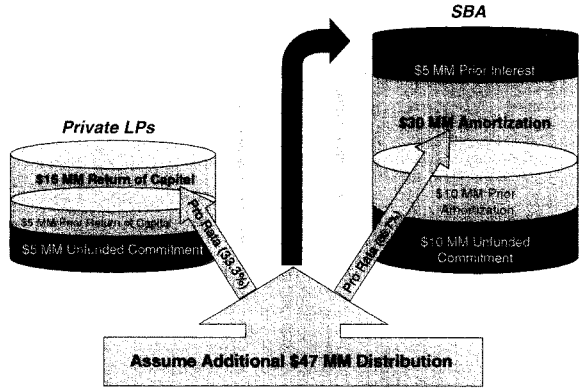
Gross Receipts Flowing To The SBIC Are Applied On A "Cash" Basis According To Distributions Rules. Assume $20 MM to distribute. Interest Is Estimated.



Distributions Pay SBA Interest First & Then SBA & Private LPs Pro Rata To Amortize Participating Debentures & Fill Private Capital Accounts. Interest Is Estimated.

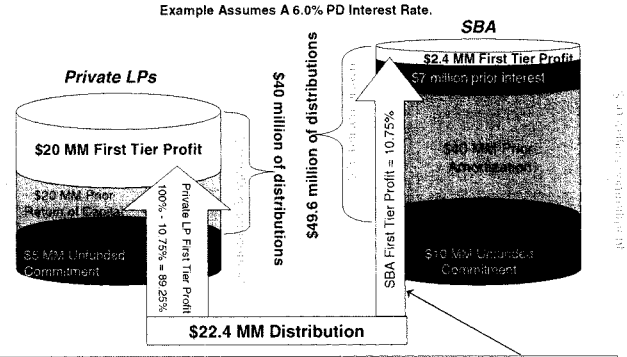


Interest First and Pro Rata Rules Apply Until SBA Debentures Have Been Amortized & Private LP Capital Has Been Returned. Interest Is Estimated.



After Debentures Are Repaid & Private Capital Returned, "First Tier Profit" Is Distributed Until Private LPs Receive Distributions Equal To Their Capital Contributions.

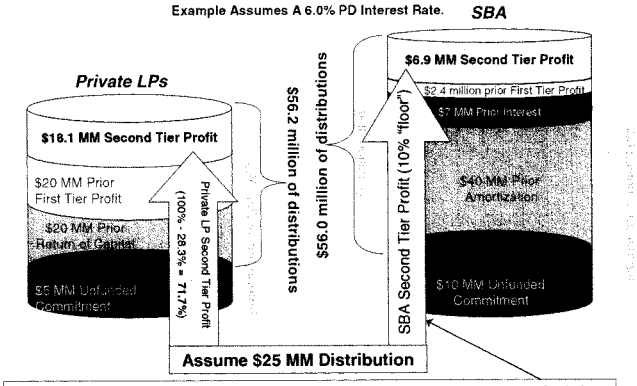
Example Assumes A 6.0% PD Interest Rate.



First Tier Profit Share With $40 MM Part. Debs. & $20 MM Contributed Private Capital
SBA Share = .25 x (40 ÷ 60) – .06
SBA Share = .25 x .67 - .06 = 10.75%

After All First Tier Distributions Are Made, Subsequent Distributions Are Governed By The "Second Tier Profit" Formula.

Example Assumes A 6.0% PD Interest Rate.



Second Tier Profit Share With $40 MM Part. Debs. & $20 MM Contributed Private Capital
SBA Share = .50 x (40 ÷ 60) – .06
SBA Share = .50 x .67 = 27.5%

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DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
109th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

August 1, 2005

The Honorable Hector Barreto
Administrator
Small Business Administration
409 Third Street, SW
Washington, DC 20416

Dear Mr. Barreto:

On July 27, 2005, the House Small Business Committee held a hearing to discuss H.R. 3429, the *SBIC Participating Debenture Act of 2005*, a bill introduced by Representative Jim Ramstad and me. This bill creates a new capital access program called participating debentures, which is designed to replace the participating securities portion of the Small Business Administration's (SBA) Small Business Investment Company (SBIC) program.

As a result of the hearing, the Ranking Member, Nydia Velázquez, and I have several questions:

1. In the opinion of the SBA, does H.R. 3429 comply with the legal requirements of the *Federal Credit Reform Act*? If not, please state the legal reasoning for your position.

2. Please explain how the participating securities program initially complied under the Federal Credit Reform Act?

3. Please state definitively whether the Administration supports or opposes passage of H.R. 3429. If you oppose, please delineate the specific provisions which are objectionable and why you find them troublesome. Also, please specify how any of these provisions could be corrected or amended in order to address the Administration's concerns.

4. Finally, how much of the participating securities program losses does the SBA attribute to the recession?

Your definitive response to these questions must be received no later than **August 22, 2005**. Should you have any questions about this request, please contact Bradley Knox at 202-225-5821 or Adam Minehardt at 202-225-4038.

Sincerely,

The Honorable Donald A. Manzullo
Chairman

The Honorable Nydia M. Velázquez
Ranking Member

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