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FULL COMMITTEE HEARING ON LEGISLATION UPDATING AND IMPROVING THE SBA'S INVESTMENT AND SURETY BOND PROGRAMS

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

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FULL COMMITTEE HEARING ON LEGISLATION UPDATING AND IMPROVING THE SBA'S INVESTMENT AND AND SURETY BOND PROGRAMS

Thursday, September 6, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., inRoom 2360, Rayburn House Office Building, Hon. Nydia M. Velázquez [chair of the Committee] Presiding.

Present: Representatives Velázquez, Shuler, Michaud, Cuellar, Moore, Altmire, Clarke, Chabot, Graves, Akin, Musgrave, Davis, Fallin, and Jordan

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

ChairwomanVELÁZQUEZ. Good morning, I am pleased to call this hearing to order. In today's hearing, the committee will examine a proposal to improve the Small Business Administration's existing investment programs and establish a new Angel investment program. This enhancement, which expands access to venture capital, will help modernize the SBA so that its service offering meet the needs of America's entrepreneurs. In June, this committee received testimony from key members of the investment community who describes the challenges facing our Nation's small businesses.

Small business relied on venture capital investment to form the pursuit of new ideas, indeed many well-known companies began a small business that grew to prominence with the help of venture capital. Several companies like Google, IBM and Microsoft would not be the industry leaders they are today if it were not for venture capital investment, yet despite this importance, it remains extremely difficult for small businesses to attract investments. This is particularly true for two key segments of the business community, early stage businesses and those located in low income communities.

Over the last 5 years, there has been a steady movement of venture capital away from small business startups and to work later stage businesses, this has not only limited the ability of small businesses to expand and grow, but also hindered their ability to generate innovative, new ideas and new products. Venture capital represents the life blood for these businesses, without it these startup companies will never reach their full potential, perhaps no Fed-

eral agency is better positioned to address this problem than the SBA.

Unfortunately, the administration has failed to press these advantages for the benefit of the small business community, it continues to withhold the support necessary for the new markets program to achieve its full potential. Similarly, the SBA has failed to explore new strategies that has proven successful at increasing venture capital investments in start ups. And perhaps most notably, the agency continues to follow outdated policies that restrict the flow of venture capital and other forms of investment to small firms. The committee print being considered will begin to reverse these policies, this proposal will renew our commitment to increase investments in low income areas by restoring for them NMVC program it also features a renewed focus on small manufacturing companies providing much needed help to communities that have suffered from a loss of their industries.

A new Angel Investment Program will also be established. This will fill the void for stiff capital that has been created by the elimination of the participating securities program. This emerging strategy is already enjoying widespread success in the private sector and will be a vital step in ensuring that start up in early stage businesses have the capital they need to grow stronger. The proposal will simplify and streamline the treatment of small businesses receiving venture capital investments. This change will ensure that entrepreneur has unimpeded access to this key form of financing. Together, these initiatives will strengthens SBA's commitment to improve investments in small businesses and automatically improve innovation among our Nation's entrepreneurs.

Our small businesses have always been the incubators for new ideas and investment has been the fuel for this great engine of American economic development. As this country continues to rely on entrepreneurs to spur economic development and create jobs the need for equity capital will only continue to grow. I would like to extend our thanks to all of the witness who will be testifying today. I am sure that their unique view and comments on the proposed legislation will be insightful as the committee moves forward in the legislative process on this very important subject.

[The prepared statement of Ms. Velázquez may be found in the Appendix on page 38.]

ChairwomanVELÁZQUEZ. I now yield to the ranking member, Mr. Chabot, for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr.CHABOT. Thank you, Madame Chairwoman, and I want to thank you for holding this important hearing to address legislation that would update the Small Business Administration programs that provide long term capital and surety bonds to small businesses. Recent events in the financial market show that small businesses will continue to face difficulties raising credit in capital through normal commercial markets. Those business owners with solid credit scores and balance sheets will have to spend more to obtain credit. Those without stellar credentials may find credit in capital very scarce. Such gaps in the commercial finance markets

are problematic because small businesses are the most significant component for creating new jobs in the economy. An economy that faces some uncertainty due to problems in the housing market will have the situation exacerbated by any limitations on small business growth resulting from restrictions on availability of capital.

During the past 6 years, this committee has heard from a variety of sources that conventional debt and equity markets do not provide adequate resources to small businesses, particularly new small businesses, ones that do not have a track record of cash flow and solid earnings. The committee also already has passed legislation that addresses improvements in the market for debt. Today the committee is considering legislation to rectify issues in the equity market for small business. Some of changes proposed in this legislation we are considering today are appropriate and necessary technical changes, for example, special small business investment companies called new called new market venture capital companies are hampered because the definition of new markets in a Small Business Investment Act is more restrictive than the one in the Tax Code.

It certainly makes sense to modify the Small Business Investment Act to improve the capabilities of new market venture capital companies to invest in poor areas. Another appropriate technical change involves raising the limits on the amount of leverage available to small business investment companies, rather than using an index for inflation. This change will provide these SBICs with greater certainty concerning the amount of funds that will be made available by the SBA, these and the other technical changes in the bill to improve the existing equity program, in my opinion, makes sense.

However I am not yet convinced that we need to create completely new programs to provide equity capital to small businesses, rather than continue to reform and improve existing programs. I would be very interested in hearing from our witnesses, their views on the best approach that the committee can take to ensure that small businesses have access to equity capital given the recent tumult in the financial markets. The other program that we are examining today is the SBA's guarantee of surety bonds, surety bonds generally are required to assuage the buyer of services that the supplier will finish the contract or some substitute will be found to do so. Surety bonds are used in many industries, although they are most prevalent in construction contracts. If a contract requires a surety bond small businesses, particularly one without a significant track record may not be able to bid because the business will be unable to obtain a surety bond at a reasonable cost.

The SBA surety bond program provides an important tool to increase the competitive capacity of small businesses to bid on various contracts, including those offered by the Federal government. The technical changes that we are considering for the surety bond program will enhance its availability and utility for small businesses. In turn, an improved surety bond program will enhance the competitive capacity of small businesses to win contracts that require the proffer of a surety bond.

Finally, the bill makes drastic changes to the definition of small business by eviscerating the long-held standard that a small busi-

ness is one that is independently owned and operated. Title V of the bill we are considering will enable venture capital companies to own, control and operate numerous small businesses, numerous small businesses without any affiliation standard at all. This will enable venture funded small government contractors to take advantage of economies of scale and scope that truly independent small businesses will not and arguably provide an unfair advantage.

In the long run, this will reduce competition in the government marketplace and increased costs to the taxpayer, that is our concern. I am willing to hear what advice our witnesses will have on reducing the potential significant adverse consequences on small businesses of this change, and hopefully we will be able to work something out between now and the future when this is taken up in the legislation, and as I have said in the past, this committee, and especially the Chair, I think myself in particular, and our staff have had a very good relationship thus far in this Congress. I hope we will work it out, although there are some challenges that we face.

I thank the chairwoman for holding this hearing and thank the witnesses who will be testifying this morning and look forward to the ideas offered by our distinguished panelists and I yield back the balance of my time.

ChairwomanVELÁZQUEZ. Thank you, Mr. Chabot. Let me state what we are considering today is the footprint of this legislation that has not been introduced. You have valid concerns, I hope at the end of this hearing today we could sit down and work out those differences because I think that some of the concerns and the points that you address will be addressed today during the process of this hearing.

Now I recognize Mr. Altmire for an opening statement.

OPENING STATEMENT OF MR. ALTMIRE

Mr.ALTMIRE. Thank you, Chairwoman Velázquez, for today's hearing and for your continued work on behalf of America's small businesses. I appreciate your leadership and the opportunity I have had working with you and the committee's staff in drafting legislation to improve access to equitable capital for America's small businesses. I also want to thank the ranking member and his staff for helping us work through some of these issues and improvement to strengthen this bill going forward.

The previous hearing this committee held on June 21st examined many of the challenges that small businesses face in acquiring investment capital. High levels of risk, regulatory and compliance costs, the cost of capital assets, limited cash flow just to name a new. The primary source of investment assistance through the SBA is the small business investment company program, it is a public private partnership that has invested $48 billion in more than 100,000 small businesses since 1958.

Notable success stories include Intel, Apple Computer, Whole Foods, Staples, Quiznos and Costco. The SBA's other two investment program, the new market venture capital program and surety bond program, have, however, demonstrated limited success. Onlysix companies currently participate in the NMVC program and

the surety bond program has become an increasingly unattractive option for some small businesses.

All three SBA investment programs are designed to provide our Nation's small business start ups with access to equity capital in order to foster innovation and create more jobs in our communities, unfortunately these programs have fallen short creating an environment where it is difficult for startups to attract initial investment.

Today, we have an opportunity to discuss how to address these challenges and beginning consideration of a legislative solution that I will soon introduce, the Small Business Investment Improvements Act of 2007. This bill will strengthen the SBIC program, expand the NMVC program, and improve the surety bond program also establishing a new office of Angel investment, the changes this legislation proposes to the current fracture of the SBIC program will bring it up to date with today's practices, it simplifies how the maximum live registration caps are calculated and revises the limitation on aggregate investment to increase overall investment in small business.

Further it will provide incentives to target investments to businesses owned by veterans, women and minorities. Changes will also be made to the NMVC program by providing incentives for investment in small manufacturing companies in low income areas and expanding the program. Doing so will ensure a wider distribution of investment nationwide and create opportunities for more small businesses to benefit from the program.

Finally, this bill will establish the office of Angel Investment that will focus on increasing equity investment in small business. Within the new Office of Angel Investment, an Angel Investment program will be developed to matched Angel groups with early stage small businesses. A Federal Angel network will be made available through SBA's Web site and grant initiatives will be established to increase awareness about the benefits of Angel investing to both entrepreneurs and investors.

The Small Business Investment Improvement Act of 2007 will reduce many of the barriers that small businesses face when seeking to obtain equity investment through the SBA and its private partners. Small businesses are the backbone of our economy generating 57 million jobs a year insuring that they are able to obtain vital capital at crucial points in development are of paramount importance to all of us on this committee. I hope my colleagues will join me in support of this effort. Again, I want to thank the Chair and the ranking member for their assistance with this bill and for holding this hearing today.

ChairwomanVELÁZQUEZ. Thank you.

The Chair recognizes Mr. Jordan.

OPENING STATEMENT OF MR. JORDAN

Mr.JORDAN. I think we had some terrible flooding in the midwest the last couple of weeks, and serious damage was done in our district. Mr. Preston, along with his team, has been in our district has been in our district working hard. When we visited you had been traveling for a week in Ohio in our district and appreciate the administrator taking time to come talk to local leaders. More impor-

tantly, families and individual business owners impacted by the floods, so we appreciate that very much.

Mr.PRESTON. Thank you.

ChairwomanVELÁZQUEZ. Any other statements?

We will proceed with our first panel. It is with great pleasure that we welcome Administrator Preston. He is the 22nd administrator of the U.S. Business Administration and agency that advocates on behalf of the nation's small businesses helps advance our economy and assists in providing financial assistance following a disaster.

STATEMENT OF HON. STEVEN C. PRESTON, ADMINISTRATOR, UNITED STATES SMALL BUSINESS ADMINISTRATION

Mr.PRESTON. Thank you very much, Chairwoman Velázquez, Ranking Member Chabot, and other members of the committee, good morning. Since 1958, the SBA's SBIC program has invested over $50 billion in over 100,000 small businesses. Forty years of performance supporting the Nation's economy. The debenture program has formed the backbone of this program and it operated without a cost to the taxpayer for the last 7 years. In 2006 alone, the SBIC debenture licensees invested $1.2 billion. About 25 percent of those investments went to low and moderate income areas, amounting to more than $300 million in LMI investments last year. We continue to focus on making more capital available to LMIs through outreach and education, we also continue to aid under the market venture program, which has made over 47 million in equity investments in 55 portfolio companies over the last 5 years. New market venture cap companies have also provided over $10 million in operational assistance in actual or potential portfolio companies.

To date, none of the new market venture capital groups have repaid the debentures and the licensees have not yet fully invested their leverage, that is not to imply anybody's default, we are not at the repayment phase of the program. We continue to support the new markets program and will assess the potential of the program as investment results become clear. In addition to SBA's program, many of, you mentioned the Angel market. Private sector Angel investing has grown, to be a significant source of capital for start ups. It has grown steadily since 2001, it is now over $25 billion which is up almost 11 percent from last year and has been aided by many of the macro economic policies of the administration. While Angel Investment is a source of critical seed capital for entrepreneurs, the administration believes that stable pro investment policies are the most effective method of encouraging activity among Angels. Over the past 5 years, Angel Investment has grown 65 percent and created 540,000 jobs in the last three years.

The administration believes that the best way to strengthen this investment is through an economic framework then encouraged investment at all levels through broad based and reasonable tax rates and reduced regulatory impediments. The administration firmly believes that the economic policy has been a factor in the rebound of the sector.

I would like to now turn to the draft legislation more specifically regarding the debenture program. SBA has no opposition to many

of the proposed changes in Title I, these changes can't clarify the formula which think is very helpful in the current program without increasing risk, they also should have low cost impact in the program, the less complicated rules should encourage funds to participate in the program. We do think the current tiered structure should remain, or that the maximum leverage should be limited to two tiers. We are concerned that a third tier would increase risk to the program and many funds receive income in returns of capital that mitigate the need for that third tier.

In Section 102 we believe the language targeting low income communities already in a Small Business Investment Act accomplishes the demographic affect desired. Turning to new markets venture capital. While the initial investments appear promising, we think it is premature to judge the program's overall effectiveness, six of the firms are in the investment stage, none of them are making payments on debentures right now. Until that happens, it is difficult for us to judge the individual performance of these groups or of the overall program. Also, since there are no fees or returns to cover the programs losses, the cost of the program will equal the operating support we provide the program in addition to the overall debenture losses, there is no offset to that. The goals of the program are important.

At this time, we think it is difficult to assess the total cost benefit relationship there. We will support the proposal to amend the definition of LMI as discussed. Turning to the Angel capital provision, while the administration believes encouraging private investment and small business is important we do not support the subsidy supported in this bill. Angel investing represents pure venture capital. We assuming that the bill would allow the government to participate in the return on a pari passu basis with the Angel investors, we suggested that we would like to talk about clarifying the language to make sure we understand what that looks like.

If that is the case, once again, we would want to work with you on clarification. More fundamentally we do not see how the program would increase the likelihood of wealthy Angel investors to invest along side the government in target investments. I think once they find attractive investments, we believe they will do so with or without government support, especially considering the size of this marketplace and the connectedness of it and increasing connectedness of it.

Also, Angel investors typically do invest side by side as we look forward at the SBA investment is limited as described in the bill. When portfolio companies require follow on capital, Angel investors could create deals beyond that cap level which would allow them to increase their returns at SBA's expense so we would want to talk about how to deal with those issues.

We welcome the suggested improvements in the surety bond program, participation has diminished. While SBA has made a number of regulatory and administrative changes there is a limit to our ability to affect changes without statutory authority so I am glad our recent regulatory effort is working, we heard favorable feedback from the industry and also acknowledge the need for some legislative changes. We recently saw the language concerning ownership interest in venture capital firms while the SBA encourages

venture capital investment in small businesses we are concerned about this provision the basic premise of small business size status, independent ownership and control could be circumvented by the provision, it could allow large venture capitalists to own several small businesses without affecting the size statuses. Furthermore such concerns could compete for and obtain contract set aside for small business concerns as well as grants and other forms of assistance reserved to small businesses. We continue to work hard to strengthen our impact through the investment division, but we have tempered those efforts with prudence and fiscal oversight focus. We have also increased our oversight to address problems and worked to improve our relationship and to reach out to industry leadership to work toward common solutions in many of the programs we have. Thank you for the opportunity to testify before the committee and I look forward to answering any questions you might have.

[The prepared statement of Administrator Preston may be found in the Appendix on page 44.]

ChairwomanVELÁZQUEZ. Thanks you, Mr. Preston.

In June, we conducted a hearing on this topic and we heard from one of the witnesses, Mr. John Wade, John May, a widely recognized Angel investor and current chairman of the Angel Capital Association. The committee was told to consider creating a government fund that automatically coinvests with Angel, this is a way to spur economic development with low cost.

The model we have proposed in the bill does just this, but your answer to creating a new proposal that will start a greater investment is always no. So you tell us that the administration's policies are sufficient to meet the need for investment in small businesses, but this is what we have, Mr. Preston, you have eliminated participating securities, you have done nothing to move the debenture program to early stage firms. Last year, only 3.4 percent of all SBIC financing went to black owned small businesses, only 1.3 percent went to Hispanic owned businesses, only 2.3 percent went to women-owned businesses, and last year SBA licenses only 10, none of which were for early stage. Five years ago, the SBA license, 40 new SBICs, more than half of which were for early stage investment. So my answer is do these numbers, my question really reflect an agency with sufficient tools to meet the investment mission?

Mr.PRESTON. Madam Chair, you covered a lot of ground in that comment. Let me just make a couple of comments. First of all, I think we are doing a lot with early stage investors. As you know, about a third of our 7a program goes to early stage investors, this debt capital but is very significant. Almost $5 billion in 7a went to early stage last year. When you look at LMI areas, I think I already noted that 25 percent of the debenture cap program today is going to LMI areas. If you look at the lending programs to minorities you will see we have a very significant percentage of lending programs going to minorities, you made a number of comments.

ChairwomanVELÁZQUEZ. With all due respect, Mr. Preston, this is about Angel capital, Angel Investment, this is about venture capital, this is not about that, 7a is not venture capital.

Mr.PRESTON. I understand that, but we are talking about getting capital to early stage businesses overall and there are a number of tiers of capital and we play a significant role in some of those tiers. I would say when you look at a $25 billion Angel marketplace and you consider launching a $25 million program where the government co invests pari passu, I, having spent much of my career in this business, am suspicious whether or not that would energize investment in the areas that you are targeting. If I am a venture capitalist or an Angel investor and putting a million dollars into an investment, asking the government for a million dollars and going through our programs first, asking for one of my partners for a million to invest in what I think is a good business, I know where they will go.

ChairwomanVELÁZQUEZ. You are not answering my question. My question is, how do you react to the fact that you are saying this is not important, this model is not the answer because we have all these other programs, but when we look at the performance they fall short when it comes to women-owned businesses, to Hispanic-owned businesses, to black and low income areas.

Mr.PRESTON. As I mentioned, the debenture program has about 25 percent in LMI, that is over $300 million. What I would also tell you is we are working on a number of initiatives, we would be happy to have your staff over to go through them. We recently hired to head all of our lending and investment operations Grady Hedgesbeth. He was Mike Dukakis's secretary of economic affairs, he is working on designing a number of vehicles with us, he has a deep economic development background, and he was the founder and president of the first bank, owned Urban Investment Bank up in Boston, which provided mezzanine and equity financing to minority and inner city businesses. This is the person we have leading the design of our new initiatives in our outreach. We are looking extensively, we are working with Treasury on CDFI.

ChairwomanVELÁZQUEZ. I guess he has a lot of work to do. With these numbers I would suggest that you go back and sit down and present this picture to him, because the numbers speak for themselves.

Lets talk about the reasons that you are citing for not creating the Angel program, you are saying the risk to the government. The proposed legislation however, Mr. Preston, will require Angels to much dollar for dollar the capital received from the SBA, thus giving Angels more risk than due private investors in the SBIC program. Why are you willing to put the government at greater risk in the SBIC program and not in this new Angel program?

Mr.PRESTON. In the SBIC program, in the debenture program, we are looking at a current pay instrument and it is a different kind of investment. I would say is I have been out there talking not only with many inner city companies, but people who work in this industry, I know you have held hearings and you know very well from your own district the challenges that people have, I believe what we need to do, and this is what we are focusing on, is a much greater focus on outreach, on financial education, on helping people understand the opportunities in the inner city. I am not sure that a co-investment with Angels is the way to do it, I do not

think it is an outreach vehicle. I think there is a real awareness issue.

And also think and this is what I have heard continually when I've done the round tables, inner city investing and rural investing can be very good business. I am very concerned about the perspective that somehow we have to help people because it is not good business. You have great transportation, proximity to customers, public transportation, you have work for sets available often real estate is cheaper. My view is there is a different way to address the issue.

ChairwomanVELÁZQUEZ. The reality here is this is not about the perception, it is about improving the investment in early stage companies, in Hispanic-owned business, women-owned businesses, black-owned businesses, and low income areas. I think this program, the Angel program, put the government at the lower risk than those of SBIC. SBA lost nearly $3 billion in the SBIC program in the last 6 years. We are putting controls, so we question the type of controls that you think you have in place to prevent the SBIC from getting the government to lose the money.

Mr.PRESTON. I agree the participating securities program has lost a lot of money. I think it was a poorly structured program and I don't think the government was protected based on its structure, so I would concur with you that the particular program has come at great cost to the taxpayer.

ChairwomanVELÁZQUEZ. Mr. Preston, currently your agency considers venture capital companies as affiliates with their business investments. As a result, the SBA adds the investment companies employees with the employees from companies receiving investment and with every other business in which the investment firm is invested. If the total number of employees exceeds 500 then the entire organization viewed as a whole by the SBA is not considered a small business, does your agency follow this same affiliation policy in the context of companies that receive investment from SBIC approved investors?

Mr.PRESTON. I do not know.

ChairwomanVELÁZQUEZ. The answer is no.

Mr.PRESTON. So I figured you knew. You wouldn't have asked the question.

ChairwomanVELÁZQUEZ. Why does your agency treat investment different when it comes from private venture capital as an opposed to an SBIC licensed SBIC.

Mr.PRESTON. My concern on this legislation, is that you have large affiliated groups getting small business contracts, we want to do everything we can to help those small businesses who truly are small businesses get those contracts that may be able to be dealt with through greater clarification of the definition in your bill.

ChairwomanVELÁZQUEZ. In your testimony, you have suggested that the way we are treating venture capital has insufficient safeguards.

Mr.PRESTON. Yes.

ChairwomanVELÁZQUEZ. I disagree. The bill that we have under consideration, or the draft bill, first, it will not require that the venture capital firm itself be a small business;two, prohibit a large company from controlling the venture capital company;three, re-

quire that the venture capital firm have fewer than 500 employees, require that the venture capital firm be located in the United States. There should certainly forestall concerns that we are allowing a large corporation to set up a venture capital company to invest in small businesses in order to obtain contracts. Under your own risk recertification rule from November last year, as long as a large corporation acquired a small business by the end of June of this year, it gets a free pass for the small firm's contracts for the next 5 years.

We have certainly not done anything remotely so egregious here. To the contrary, we have taken steps to prevent such abuses. How can you say that these safeguards are insufficient?

Mr.PRESTON. Madame Chairwoman, I think a venture capital firm with 50 people or even 100 people can be a very, very significant enterprise. If you are looking at the employee base of the firm itself, you will get an enormous amount of leverage off of that employee base. Now, if you want we can get into the recertification discussion, but specifically with this bill, I am concerned that if you are looking at the people who work at the fund itself, you are missing—a 100-person fund can leverage billions and billions of dollars.

ChairwomanVELÁZQUEZ. What about the SBIC with 50 employees or 500, they are not restricted.

Mr.PRESTON. The SBICs in practice are relatively small funds. If you see an inconsistency in the SBIC piece, I would be happy to address that separately, I am addressing what you have in your bill right now, and that's what I'm trying to focus on.

ChairwomanVELÁZQUEZ. The venture capital firms that we are talking about are small firms, these are not large firms.

Mr.PRESTON. All I am saying is I think as we draft the language in this legislation which should make sure that is, in fact, the case, a 400-person venture capital firm is enormous. I think the largest firms in the country may not even be that big, I think it is very important we put the property restrictions in it.

ChairwomanVELÁZQUEZ. We do, sir, we do, sir.

Mr.PRESTON. If it is the right firm and we put some safeguards in there, it may be fine and many of the small businesses we should be working with.

ChairwomanVELÁZQUEZ. We will be working with you, we will be working with a minority. Let me say this, no one in this committee has fought nail and tooth regarding big businesses taking away fair contracting tended to go to small business, I am not going to jeopardize this here.

Mr.PRESTON. Ma'am, I have ever never ever doubted your commitment to small business and I do not think you could doubt mine, I think we can work on this collaboratively.

ChairwomanVELÁZQUEZ. I recognize Mr. Chabot.

Mr.CHABOT. Thank you, Madam Chair. Administrator Preston, thank you for your appearance here this morning. I think I understood you to say the investment community—first of all, there is about $25 billion that is already being invested by the Angel.

Mr.PRESTON. Yes.

Mr.CHABOT. And this is a program, 25 or 100 million, depending on the way one looks at it. As a practical matter, the investment community may see government involvement as a yellow flag, that

this is an area that is risky, and therefore could potentially have the opposite impact. Did you say that in so many words?

Mr.PRESTON. What I said in so many words is a broad and deep market with a fair degree of connectedness among investors, the connectedness is growing. I think these Angel networks that are merging are very favorable for small business and very favorable to enhance investment. And as a result, I am suspicious of the value an Angel investor would see in calling up us for money with going through a government process in getting qualified and dealing with filings as opposed to going to somebody sells. There is no kind of added return to them, we are not enhancing their return, and so I guess I view this as limited value.

Now, I do agree with the chairwoman in saying and I appreciate that our return would be pari passu, I think this is important to do this. To the chairwoman's earlier comment that is not what happened in the participating security program, and that is one of the reasons the government lost so much money.

Mr.CHABOT. Thank you. I think you stated it is your belief that the best way to strengthen the Angel investment market is not necessarily through the government market, but rather through creating an economic framework that encourages investment at all levels, I think you specifically said, I think your terminology was the macro economic policies of the administration; could you elaborate a little bit?

Mr.PRESTON. I think through a favorable tax environment that encourages investing and people's ability to get returns out without an onerous tax burden is very favorable, a favorable regulatory environment. Since the beginning of the administration, we have sense a growth in the Angel market. I would also mention, Mr. Chabot, that we do see an outreach opportunity here and an access issue in certain areas of our country. I hear it time and again out in the field. We do think it is important for us to play a role there.

The other thing I would say, I would not disparage the importance of the lending program in this area. In your own State, you may not be aware, it is further north than your district, but we are actually doing a pilot right now where we are coupling our lending programs with equity investment as soft of a 1, 2 punch to give people a full capital structure when they are having had a hard time getting capital elsewhere. So there is a lot we can do that is very incremental here.

Mr.CHABOT. I think you noted that the proposed structure of the Angel Investment program could permit the possibility of a conflict of interest. Would you elaborate on that?

Mr.PRESTON. This is something and this may be able to be dealt with through some of the language, but I think we are maxed out, if I recall, at $2 million. What may well happen is you look at follow on investments, we may come in on that first or second tier with a particular valuation and investment structure relative to the other investors, as you do follow-on investments, we may not have a seat at the table. Those could be done at a different valuation lower or higher, it could dilute our interest, there are a number of things that could happen that would be potentially detrimental to our interest in the program.

Mr.CHABOT. Thank you. Finally, you expressed some concern that the legislation does not provide for repayment of proceeds if the Angel investment is not profitable, could you give some examples where that sort of thing could happen?

Mr.PRESTON. I am trying to recall the exact language, I think it described the repayment of as being out of profits and profits typically refer to returns over and above your original investment. My comment had to do with if there was a certain amount of capital and return that is returned to the investors that we participate in the entire pie, not just the profit piece. Based on our discussions at a staff level, we understand that is the intention, we just want to make sure that the language is as clear as possible.

Mr.CHABOT. Thank you very much, I have no further questions.

ChairwomanVELÁZQUEZ. Mr. Altmire.

Mr.ALTMIRE. Mr. Preston, I want to focus on one of the things that you had a discussion with the chairwoman about the new markets venture capital program is the only program that has been specifically designed to increase investment in small businesses in low income areas specifically. So can you talk about if you feel that this is still a worthwhile investment, if so why has it not been requested to be funded over the past 4 years.

Mr.PRESTON. It is the only program specifically designed and structured to go exclusively into those areas. Right now we are still in the funding stage of that program, we are not at a point where we have seen any returns coming out of it. In addition we do not know how it is performing. Secondly in terms of the cost of the program there are two elements to the cost, number 1, any loses in the program the government will fund because there are not any fees to cover it. Number 2, we provide operating costs, based on our estimates, we do not know where we will end up. We can easily see a loss of 30 percent on the money invested if you look at the operating costs and the potential losses in the program. If you look at, as an alternative, the debenture program where we are putting out $300 million and it is a zero subsidy program, we are putting out a lot more money out there at a zero cost to the taxpayer other than the administrative costs, so we have concerns with how it will ultimately turn out. In any case, it will be a fairly significant cost to the taxpayer.

Mr.ALTMIRE. In the interest of time with a vote on, I will condense my questions about Angel Investment. Can you talk about what you see as the value of mentorship with regard to Angel Investment with the programming, and does the agency support low cost mentorship and management advice through that program?

Mr.PRESTON. I think, somehow getting mentorship counseling technical assistance for small business is very important. And obviously as you know we have a large network of people that we fund through SBDCs, women's business centers as well and our district network of 70 locations where we counseled over 300,000 people last year, a million 4 overall, so small businesses at every stage can use counseling and mentoring.

Mr.ALTMIRE. Thank you.

ChairwomanVELÁZQUEZ. Will the gentleman yield?

Mr.ALTMIRE. Yes.

ChairwomanVELÁZQUEZ. I would like to follow up on your answer regarding the new markets venture capital program. Are you saying that you are just waiting to see when the program they repay to the government.

Mr.PRESTON. The program has not begun to repay. We do know, based on the way the program is structured, that the cost will be the operating costs that we fund plus any losses, because unlike the debenture program, there are not fees in plus to cover those losses.

ChairwomanVELÁZQUEZ. Have you taken any steps to strengthen existing companies in this program?

Mr.PRESTON. We provide millions of dollars of operational assistance.

ChairwomanVELÁZQUEZ. Have you done any evaluations to date?

Mr.PRESTON. Yes. We looked at those programs to date.

ChairwomanVELÁZQUEZ. Do you have a report of how those companies are performing?

Mr.PRESTON. We can share that with you.

ChairwomanVELÁZQUEZ. Will you be able provide today the committee with such a valuation?

Mr.PRESTON. I do not know if we can turn that around today but we certainly can do that expeditiously.

ChairwomanVELÁZQUEZ. Now I recognize Ms. Clarke. No, lets take a recess here and we will come back and resume as soon as we finish voting.

ChairwomanVELÁZQUEZ. Ms. Clarke. The Committee is called back to order.

Ms.CLARKE. Thank you very much, Madam Chair, and Ranking Member Chabot, for holding this very important hearing today. As has already been stated by our Chair, Ms. Velázquez, the SBA funding and programs such as the SBIC's participating security program has had a negative impact on the SBA's ability to provide capital investment for minority entrepreneurs. Only 3.4 percent of all financing in the SBIC program went to small businesses that were majority black-owned. About 1.4 percent of all SBIC investments went to small businesses that were Hispanic-owned. And 2.37 percent of the SBIC investments went to women-owned businesses.

I was listening to your comments to our Chair, and you sort of did an exchange there where you said you have no doubt of our Chair's commitment and there should be no doubt of your commitment. But when you look at results like this—and I am really result-oriented—it would seem to me that there would be an urgency and a drive to see these types of results, you know, really change dramatically. And I kind of got the impression that there was no real urgency or recognition of how poor this performance truly, truly is. If your agency were a corporation that produced results like this, you would not survive. And I think we need to look at business as business, not as, you know, some sort of an entitlement or some sort of a social program. We are talking about worthy businesses and companies that are not being impacted by your mandate, by your goals. So I wanted to ask what goals you have set for your agency when you have such abysmal statistics.

Mr.PRESTON. I think you are honing in on, very specifically, the debenture program and women and minorities. If you look at our other programs, all across the board, I think our statistics are very good in many of those areas.

Ms.CLARKE. Let's just then concentrate on another program, new markets venture capital. Despite that to date, despite the fact that Congress created this program to address unmet equity needs in low-income communities, to date the NMVC program has made a total of 149 million, including 62.4 million of non-Federal funding, oriented towards low-income areas in some 15 States throughout the United States. There are only six, six NMVC companies participating in the program, and the fiscal year 2008 budget allocates no resources to bring more companies into the program. The additional funding is crucial to ensure that the NMVC program meets its full potential to improve economic development in low-income communities. It is just, you know, the rhetoric is on one end, the results on the other. The emphasis is really not there. And, you know, you can't paint a picture of roses when the numbers say it all.

Mr.PRESTON. Yeah, but I think it is important to talk about what numbers we are talking about. You are mixing LMI with women and minority. I think our LMI numbers for these investment programs are actually quite good. And we are working very hard to improve them. I think our women and minority numbers for most of our programs are very good. I am concerned in the debenture investment program—and that is what we are talking about—that these numbers are not very strong.

Now let me tell you how we have been working to address those issues. First of all, we have been doing a tremendous amount of outreach to understand what the problem is. We did an entire symposium called Access to Venture Capital for Women and Minorities. We brought in a number of people from the Hill, from trade groups that are very focused on this issue.

I mentioned earlier, ma'am, I am not sure if you were in the room when I mentioned this, but we hired a new person to run all of our investment programs, who headed—who was a secretary for economic development for Mike Dukakis in Massachusetts. He headed the first ever bank-owned venture firm that focused specifically on minority and inner-city investment. They put over a hundred million dollars out there. He is an expert in this area. He is working actively with us right now to look at designs to improve our investment in critical areas.

So this issue with where the debenture program has invested over the years, specifically for the categories you mentioned is not new, and as such, it is an issue we are trying to understand.

The other programs have done much more in those areas. We have tried to address this historically by finding venture firms. We don't control their investments in the debenture program. But we have tried to address historically by finding debenture firms with minority representation on their investment committees and in senior management. But that does not seem to have moved the needle dramatically at this point.

But I think we have got, you know, a lot under development. We are looking at a number of different mechanisms. As I said to the

chairwoman, we would be happy to get over here and go through all the different structures we are looking at. We are working with a number of people in various industry groups that really care about these issues to find structures that will have a lasting impact. So we are working on it. But this is, you know—but I don't disagree with you. I think the women and minority representation in that particular program is low.

Ms.CLARKE. Thank you, Madam Chair.

ChairwomanVELÁZQUEZ. Mr. Akin?

Mr.AKIN. I didn't have any questions.

ChairwomanVELAZQUEZ. Mr. Chabot?

Mr.CHABOT. Nothing.

ChairwomanVELÁZQUEZ. We are good.

Mr.PRESTON. I would love to come over and see you all and spend time with you.

ChairwomanVELÁZQUEZ. Sure. Thank you.

Mr.PRESTON. We will schedule that.

ChairwomanVELÁZQUEZ. Sure, Mr. Preston. Thank you very much for your appearance this morning. The gentleman is excused.

ChairwomanVELÁZQUEZ. I would ask the witnesses of the second panel to please come forward.

ChairwomanVELÁZQUEZ. Mr. Peterson, are you ready? We are going to start with you.

Mr.PETERSON. Thank you, ma'am.

ChairwomanVELÁZQUEZ. Let me make an introduction. I just want to make sure that you know you are going to be the first witness.

I want to welcome all of you. Our first witness is Mr. William Peterson. Mr. Peterson is Vice President and Public Affairs Officer for CNA Surety, a nationwide surety and fidelity funding company. Prior to his current position, Mr. Peterson served four terms in the South Dakota House of Representatives, and was majority leader in that body for 4 years. Mr. Peterson appears today on behalf of the Surety and Fidelity Association of America and the American Insurance Association, which together represent the interests of surety and insurance companies nationwide. Mr. Peterson, you will have 5 minutes to make your presentation. Welcome.

STATEMENT OF WILLIAM G. PETERSON, ASSISTANT VICE PRESIDENT AND PUBLIC AFFAIRS OFFICER, CNA SURETY CORPORATION, SIOUX FALLS, SOUTH DAKOTA; ON BEHALF OF AMERICAN INSURANCE ASSOCIATION AND THE SURETY AND FIDELITY ASSOCIATION OF AMERICA

Mr.PETERSON. Thank you, Madam Chair. I am truly honored to be here with you and the other members of the Committee today and the other ladies and gentlemen present. I am a vice president and public affairs officer for CNA Surety Company, which is headquartered in Chicago, Illinois, although my office is in Sioux Falls, South Dakota. CNA Surety Company is the largest publicly traded surety and fidelity bonding company in the United States. We write bonds from the smallest commercial to multimillion-dollar contract bonds. We have been a participant in the SBA surety bond guarantee program since 1994, and we are honored to be the Small Business Administration's partner of the year in both 2005

and 2006. We have been and continue to be a significant writer of these bonds under the bond guarantee program.

My purpose today, Madam Chair and members of the Committee, is to be a strong advocate for our company and for our industry for the continuance of the SBA's bond guarantee program, but also to suggest some changes to it which we feel will make it a much stronger program both for contractors, small and emerging contractors, for the taxpayers, for the general public, and for the surety industry.

I think we need to start with one simple question. Why is this program important? It is important because, ladies and gentlemen, our country has many unmet infrastructure needs, as was made apparent by the tragic collapse of the bridge in Minneapolis just a month ago. Small and emerging contractors in the United States can play an extremely important role in the rebuilding of America, and yet it is also true that historically small and emerging contractors have had difficulty in getting the bonds required for contract projects.

The role of bonding companies, surety companies and contract bonds also will play an important role in the rebuilding of America, because bonds have one simple purpose: They are there to protect the taxpayer and those who would fall underneath the contract of a contract provision. We pay when a contractor either fails to perform their contract or fails to pay their subcontractors and others.

Fortunately, there is a bridge to cover that between the small and emerging contractor and the surety industry. That bridge is the Small Business Administration and its bond guarantee program. This program will continue to play an important role as we move forward to rebuild the infrastructure of the United States. But a well-run program must assure the surety industry of a consistency of participation requirements and also administrative procedures.

With that in mind, Madam Chair, we have five suggestions for improvement to this legislation and to the program which I would like to share briefly with the Committee today. First and most importantly, we would ask that this legislation would prevent in the future the unraveling of bond guarantees by the SBA. There are two parts to the bond guarantee program. There is part A, there is part B. I will not go into the details of those at this time. But there has been in the past, a past history, the Small Business Administration has rejected the claim even though the bond has been prior approved or the bonding company has been prior approved. That needs to stop. Once the company is approved, once the bond is approved, if there is a claim the Small Business Administration must step up and guarantee their payment under that bond.

Secondly, we recognize as an industry that the SBA cannot be self-sufficient. We understand that a study is being proposed to look at the funding structure of the SBA. As an industry and as a company, we strongly support that study and are willing to participate in it.

Third, we strongly believe that there needs to be an alternative dispute resolution agreement. Currently, if there is a dispute between the SBA and the surety, the only alternative we have is litigation. And as we all are aware, litigation is time-consuming and

it is expensive. There are better ways to resolve disputes between our industry and the SBA.

Fourth, we believe that there should be transparency of the fee structures of the SBA, and also a prohibition against price controls on surety. For many years we had to operate under the prices as established in 1987. That is 20 years ago, and a lot has changed.

Finally, we also support increased staffing for the SBA across this country, and stronger surety education for SBA staff. We feel that will work to the benefit of the SBA, small and emerging contractors, and our industry.

What I really want to do in conclusion, Madam Chair, is to make a very firm commitment to you, to the members of the Committee, to the SBA, and to small and emerging contractors that we as an industry stand by to help, that we are committed to making this program work for everyone. We will work with the SBA, we will work with small emerging contractors on these issues and others.

I want to thank you for your time and attention today. It is truly appreciated, and I will stand by for your questions. Thank you, ma'am.

ChairwomanVELÁZQUEZ. Thank you.

[The prepared statement of Mr. Peterson may be found in the Appendix on page 58.]

ChairwomanVELÁZQUEZ. Our next witness is Mr. Robert More. Mr. More is a partner at Domain Associates, a venture capital firm with offices in Princeton, New Jersey, and San Diego, California. Mr. More is testifying today on behalf of the National Venture Capital Association, a trade association based in Arlington, Virginia, that represents over 460 venture capital firms, which currently comprise approximately 90 percent of all the venture capital under management in the United States. Welcome.

STATEMENT OF ROBERT J. MORE, PARTNER, DOMAIN ASSOCIATES, L.L.C., SAN DIEGO, CALIFORNIA; ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION

Mr.MORE. Thank you very much. Good morning. Domain Associates, for your information, we invest exclusively in young life sciences-focused businesses, and I am also a member of the NVCA, National Venture Capital Association. Thank you for the opportunity to share today the challenges that our small venture-backed businesses have faced as it relates to current SBA policies, and why we believe the Small Business Investment Expansion Act of 2007 is a positive step towards fostering the type of private-public partnership that will allow the United States to sustain its economic leadership for years to come.

In 2006, venture-backed companies accounted for 10.1 million jobs and 2.3 trillion in U.S. revenues. As the chairwoman mentioned earlier, companies that were once small venture-backed businesses include Google, Genentech, Starbucks, Microsoft, and Federal Express.

Today I am here on behalf of the next Google or Genentech that is currently being funded by a venture capital firm and is significantly disadvantaged by current SBA policies. Specifically, we are troubled by the SBA's recent interpretation of its affiliation rule in

determining whether a company meets the small business criteria. Under the existing affiliation requirements, a business concern can have no more than 500 employees, including its affiliates, to qualify as a small business. Under this requirement, most venture-backed businesses would meet the criteria. However, SBA has recently applied a formula which sweeps in the venture capital firm and the employees from every company in which the venture capital firm invests when considering a venture-backed company for small business classification.

Unfortunately, I have been involved in one of those instances in the past year. Approximately 9 months ago, one of my firm's portfolio companies filed a new drug application with the FDA and requested a small business waiver for the FDA's application fee. The fee was approximately $900,000. The FDA requested that the SBA conduct a formal size determination with respect to the company's eligibility. The company filed the appropriate paperwork, which showed that during the 3-year period prior to the filing of the NDA, they averaged 7.25 employees.

A month later, the SBA notified the company that it had determined that Domain Associates controls the company, and requested information with respect to Domain's ownership in all of the other unrelated portfolio companies. If Domain was deemed to control any of the other companies, they would be deemed affiliates of this company and their employees would be counted in the total.

We informed the SBA that Domain only has the right to elect one out of six directors, and neither Domain nor any of the three other venture capital firms invested have the ability to exercise control over the company. In response to this explanation, the size specialists at the SBA responded by saying, ″That may be true, but the SBA does not deal in the real world.″

Last week the company was advised by the SBA that after more than 7 months they are still working on the matter. It is difficult to understand how the SBA justifies their position when it directly contradicts language in the Small Business Investment Act, which seems to address this very issue. Ownership by a venture capital firm should not trigger the affiliation rule for programs that were created under the SBIA. It appears that the SBA has a gross misperception that small businesses that receive venture backing should not be considered a small business.

But our industry is focused on building companies that will commercialize a product or service. We typically enter an investment when the early-stage research has been completed. Therefore, a small business must leverage other sources of financing to bring research to the stage where it can be commercialized by having a venture capitalist. Without this SBA support, many technologies would linger on the shelf because they would not reach the stage where they could be brought to a venture capitalist.

Intuitively, it would seem the SBA would want to fund venture-backed companies because these companies have already been vetted by professionals who think highly enough of the management team to invest. Unfortunately, this is not the case. The current interpretation by the SBA could be likened to a situation in which the NIH would refrain from funding any project at a well-endowed

academic institution because they have a lot of money behind them.

NVCA supports the Small Business Investment and Expansion Act, specifically Title V, which will resolve the SBA's affiliation issue and which will clarify SBA's affiliation rules by ensuring businesses with venture capital investment are not penalized.

It will also put in place proper safeguards to ensure this cannot be exploited by large businesses by specifically defining a venture capital operating company. No other asset class supports the premise more that small businesses are the lifeblood of the U.S. company than venture capital. We are not sure what world the SBA operates in, but in our world of the small businesses, all small businesses should have access to the same benefits. We are confident that the proposed legislation is a positive step in keeping us all in the real world, and assuring that the United States maintains its competitive edge by supporting small businesses of all kinds.

ChairwomanVELÁZQUEZ. Thank you Mr. More.

[The prepared statement of Mr. More may be found in the Appendix on page 66.]

ChairwomanVELÁZQUEZ. Our next witness is Dr. Scott Koenig. Dr. Koenig is the president and chief executive officer at MacroGenics, a Maryland-based company focused on research and development of products for the fields of oncology, inflammation, allergy, and infectious diseases. Dr. Koenig is also a member of the Board of Scientific Counselors at the National Institute of Allergy and Infectious Diseases at the National Institutes of Health, and is testifying today on behalf of the Biotechnology Industry Organization, a national organization that represents the interests of America's biotechnology industry. You have 5 minutes to make your presentation. Welcome.

Dr.KOENIG. Thank you very much, Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee. I appreciate the opportunity to testify before the Committee regarding the Small Business Investment and Expansion Act, and the critical role venture capital in small biotechnology companies. I am Scott Koenig. I am the president and CEO of MacroGenics, a private venture-backed biotechnology company in Rockville, Maryland. Prior to this, I was senior vice president of MedImmune, and I have worked at the National Institute of Allergy and Infectious Diseases. I am also currently chairman of the board of Applied Genetic Therapy Corporation, in Alachua, Florida, which is also a venture-backed company.

STATEMENT OF SCOTT KOENIG, M.D., Ph.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, MACROGENICS, ROCKVILLE, MARYLAND; ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

Dr.KOENIG. MacroGenics' mission is to develop immune-based therapies to treat patients with cancer, autoimmune disorders, allergy, and infectious diseases. MacroGenics was founded in 2000, and has 87 employees. We do not yet have an FDA-approved therapy, and we just started our Phase 3 clinical testing of a

monoclonal antibody to treat new onset juvenile diabetes patients, and have several other products in development.

I am testifying today on behalf of the Biotechnology Industry Organization, BIO, which represents more than 1,100 biotechnology companies and other organizations. The vast majority of BIO's members are small, early-stage research and development-oriented companies like mine, most with fewer than 50 employees, and do not have marketed products.

The largest obstacle to delivering on the scientific promise of biotechnologies is accessing sufficient capital to perform the research and development. Biotechnology research has a long road from preclinical research to FDA approval. It takes between 8 and 12 years to bring a biotechnology therapy to market, and costs between $800 million and $1.2 billion. Without product revenue, biotechnology companies are almost entirely reliant on the capital markets to fund the research and development.

Typically, a biotechnology company will begin its fund-raising for its lead product in development. In the case of MacroGenics, our lead product is this monoclonal antibody to treat patients with new onset juvenile diabetes, which we are now beginning the Phase 3 studies. To get to this point, we undertook three rounds of private funding, which has involved about a dozen venture capital companies. Despite the extensive fund-raising that a biotechnology company undertakes for the lead product, these funds are generally not interchangeable but are, rather, tied to specific milestones to support the lead product development.

To develop an early-stage therapy, a company now has to find secondary sources of fund-raising. At the very earliest stages of development, this is particularly challenging. And it is in this capacity that other sources of financing, like the small business innovation research grants, have been instrumental.

Venture capital financing plays a very critical road in the development of small biotechnology companies, especially since emerging biotechnology companies do not yet have an FDA-approved product on the market, and therefore lack any significant sources of revenue. Unfortunately, small businesses do not have the internal resources to overcome and wait out the market imperfections. This is key, because if private capital market is the only financing option available to small biotech companies, then good science will inevitably be delayed. This will impact patients, which I care deeply about, and this will also impact the economic development of our high-technology industry and this part of our economy.

This is not a criticism of the venture capital community. Venture capitalists are adept at evaluating scientific merit of research and the strength of a company's intellectual property and management. The U.S. Is the world leader in biotechnology, and this in large part can be attributed to our robust capital markets. However, some science is just too high-risk or too early-stage to entice venture capital investment. This particular failure in the private capital markets is often referred to as the ″valley of death,″ because it is at this point at which good science can wither for lack of funding. At this juncture, a larger company can generally have access to capital through existing revenues or bank loans to overcome the shortfall. However, this is really not an option for a small bio-

technology company. Because of the very long times for development of these biologics, small biotechnology companies may not be able to pay a loan for a decade or more, or may want to use the loan to pay the interest on the loan, and most banks won't provide that for them.

The good news is that small investment can bridge this funding gap. Funding options available to small biotechnology companies include Angel investors, historically the SBIR grants, and more recently a very small, select set of venture capital philanthropists.

However, funding gaps continue to persist. This is exacerbated by the SBA's use of outdated rules and regulations to define small businesses that in large part exclude many of the small biotechnology companies from accessing grants or programs. The SBA's decisions have real impacts on patients awaiting cures, our employees, and the economy.

BIO supports and applauds the Committee's efforts to recognize the importance of private capital financing and the unique financing challenges facing small businesses. The Small Business Investment Expansion Act addresses the unique financing challenges of small businesses, and will modernize the SBA's rules. The Committee's foresight will help ensure that the SBA programs and grants assist both the mom-and-pop operations as well as the small cutting-edge technology companies.

This legislation will also impact U.S. competitiveness. While the SBA holds onto outdated rules, other countries are moving forward to support and recruit high-technology companies. We cannot take for granted that the U.S. will always lead the world in biotechnology.

Congress can continue to support small domestic biotechnology companies by allowing the government to partner with companies that need resources at key stages of development that are not readily available in the private capital markets.

Again, I appreciate you allowing me to testify today.

ChairwomanVELÁZQUEZ. Thank you, Dr. Koenig.

[The prepared statement of Dr. Koenig may be found in the Appendix on page 75.]

ChairwomanVELÁZQUEZ. Our next witness, Dr. Robert Atkinson. Dr. Atkinson is president of the Information Technology and Innovation Foundation, a Washington, D.C.-based technology policy think tank that is focused on issues of technology, innovation, and information policy. Dr. Atkinson has an extensive background in technology policy. He has conducted groundbreaking research projects on technology and innovation. He is a valued adviser to State and national policymakers, and a popular speaker on innovation policy nationally and internationally.

You are welcome, sir, and the rule is 5 minutes. Thank you.

STATEMENT OF ROBERT ATKINSON, PRESIDENT, INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION, WASHINGTON, D.C.

Mr.ATKINSON. Thank you, Madam Chairwoman, and Mr. Chabot, and members of the Committee. I appreciate the opportunity to be here today to talk about the proposed legislation and the SBA in-

vestment programs. I want to talk about it somewhat in the context as the last speaker, in terms of national competitiveness in an economy—in a world economy where cost is really the driver of a lot of activity in Asia and other countries. The U.S. Competitive advantage has to be innovation, and entrepreneurship plays a critical role in that. So I think these issues that you are focusing on are central to our economic future.

I have been involved in these issues for many years, early, early on, when I was with the Office of Technology Assessment, which was an arm Congress. I was the first director of the Rhode Island Economic Policy Council. In fact, when I was there we helped create an SBIC-funded venture fund in the State that was very successful, focused on small and early startup companies.

I have also written extensively on these issues, most recently a Kauffman Foundation-funded report called the 2007 State New Economy Index, which looked at a whole number of indicators, including entrepreneurship indicators by State, and found very interesting results of how entrepreneurship is actually active, and venture capital around the country.

I am going to jump right into I think—kind of the main sort of point, I think, of this is there is clearly a debate about what the role of the Federal Government should be in this space. And there is no question that we have got the best venture capital markets, the best capital markets in the world in my view. And to be sure, there is no question that the lion's share of funding for entrepreneurial ventures should come, does come, and will come from the private sector. But that doesn't mean that there is not a role for government to fill in gaps and to go to some of the market failures.

Our last speaker alluded to the ″valley of death″ being just one of the market failures. Let me suggest there are two big reasons why there is a critical role for government. One is in the last decade what we have seen is a significant increase in the amount of venture capital invested. It has doubled since 1995-96, but according to NSF data, the share of that investment going to zero and first stage deals has dropped by half. So we have seen a big expansion of the industry, but much more focus on later-stage big deals. Again I don't blame the industry for doing that. I understand why that happens. But the result is that there is a gap there.

The second gap relates to geography. Venture industry, 79 percent of venture investments go to the top—go to 10 States. This is up from 2000 from 69 percent. So the industry actually at the peak in 2000, which was the peak of VC investing, the industry has actually gotten more concentrated.

A large share of the funds go to two States, California and Massachusetts. Again, there is nothing wrong with that. I don't blame the industry for doing that. But what it means is large portions of the Nation simply don't have access to those kinds of investments. One of the responses to that is a number of States, at this count 44 States have established some sort of programs to fill that gap. Sometimes they partner with the private sector, sometimes with community organizations.

For example, Pennsylvania's Ben Franklin partnership program guarantees up to 25 percent of the loss by a qualified investor who makes an investment in Pennsylvania venture firms.

Wisconsin recently established an Angel network.

So the States recognize that this market is not perfect, and they are acting. But I would argue that the Federal Government needs to work with the States, needs to complement what they are doing, if for no other reason than States, even though they are doing some of this activity, their inclination—having worked for a Governor I understand the inclination—is to go for very big deals, recruit the big company to come, do the press release, get a lot of credit. Building an entrepreneurial economy, it is hard to get credit for that. You don't see the results for many, many years. The results can be small at the beginning.

So with regard to specific comments on the bill, again I commend the bill. I just make, I guess, a couple of comments. One is on the SBIC program, I strongly agree with the Committee on this, that the focus of SBIC should be pushed backwards to smaller deals, to earlier-stage deals. That is the market failure. I don't think we need to be substituting for the private sector here.

One suggestion I might make would be you propose that 25 percent go—at least 25 percent go to smaller enterprise, which I fully support. You might want to add, in my opinion, something on the size of the deal, perhaps saying some portion of the funds have to go to deals less than $2 million.

With regard to the Angel fund, again I think there is a gap there. And I think providing an Angel fund is an important step to do that. One suggestion I might have would be to require more. Right now it is two Angels as part of the group. I would expand that to maybe five or even ten. I think having part of the goal of government here is to build networks, not just to provide money, and sending a message that we want more Angels to partner together.

And more of my comments from the testimony—but my time is almost up, so my last point is I think we shouldn't underestimate the importance of the grant program that you proposed. Again, a lot of the market failure there is about information and coordination. And so I think having a grant program, particularly if States were to partner that or local communities, where they could then help build these networks and help them manage these networks, I think that would be very important.

My one last suggestion would be perhaps adding a cash match requirement if government is going to be a player. I think we could help leverage that. I think States would be happy to participate and contribute some of their own funds to that.

So, again, thank you, and I commend you for your efforts.

ChairwomanVELÁZQUEZ. Thank you, Dr. Atkinson.

[The prepared statement of Mr. Atkinson may be found in the Appendix on page 80.]

ChairwomanVELÁZQUEZ. Our next witness is Mr. Lee Mercer. Mr. Mercer is president of the National Association of Small Business Investment Companies, and has served in that capacity since 1996. Before joining NASBIC, Mr. Mercer held positions in both the private and public sectors as a partner in a New Hampshire law firm, a government program manager for Digital Equipment Corporation, and president of two privately owned companies. Welcome.

STATEMENT OF LEE MERCER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr.MERCER. Thank you. Madam Chair, Mr. Chabot, members of the Committee, thank you for the opportunity to appear today.

On behalf NASBIC, I would like to start by saying that we support the SBIC provisions of the draft legislation under consideration. If enacted, they will improve the debenture program, make it more—

ChairwomanVELÁZQUEZ. Can you bring the microphone closer to you? Thank you.

Mr.MERCER. Sorry. You would think I would learn after all these years.

We do support the provisions, the SBIC provisions in the bill. If enacted, they will improve the debenture program and make it more attractive to private sector management teams and investors.

As Administrator Preston emphasized, since its beginning in 1958, the SBIC program has provided approximately 50 billion of long-term debt and equity capital to more than 100,000 small companies; 2.9 billion of that was invested in a little over 2,100 companies in fiscal year 2006. And the numbers will be down slightly, but not too much in fiscal year 2007.

Many of the most well-known companies in the country have received early financing from the program, including Intel, Apple, Callaway Golf, Whole Foods, Palm Computing, Staples, Quizno's, Federal Express, Outback Steakhouse, Costco, Mothers Work, Build-a-Bear Workshop, and finally Heelys, if anybody has seen those.

Thirty percent of all SBIC investment dollars in fiscal year 2006 went to companies that had been in business only 2 years or less at the time of investments. SBICs have been a crucial source of capital during those early and difficult years. SBIC financing supports jobs and job growth. Small businesses receiving SBIC financing in fiscal year 2006 employed approximately 286,000 individuals, an average of 135 employees per company, and the median was 35. SBICs play an important role in financing local businesses in States and geographic regions not generally served by non-SBIC private equity funds. Of the 2,100 U.S. small businesses that received 2006 financing, 40 percent were located in LMI areas. They received 23 percent of the dollars invested that year.

Now the SBIC program is at a critical crossroad. As detailed in my testimony, unleveraged bank SBIC program, long a leader in terms of dollars invested in small companies, has become a negligible part of the SBIC program in terms of dollars invested. Likewise, the participating security program is unfortunately, because it was an early-stage focus program, ramping out of existence. It is a victim of what we feel was an erroneous decision by OMB that the participating security is not a debt security for the purposes of the Credit Reform Act, and thus not a qualifying security for subsidy scoring purposes.

That leaves the debenture program as the sole mainstay of the SBIC program at present. It has been growing slowly over the years, but not nearly fast enough to fill the void that is being left by the exit of the bank-owned SBICs and the participating security funds. However, the debenture program does have the potential to

grow much larger if the SBIC program changes in the bill are enacted. They will simplify the program, always good for anygovernment-industry partnership, and make investment rules relative to the maximum that can be invested in any one company closer to industry norms. That is a critical provision to attract good managers and important to the portfolio companies themselves.

These changes, together with the regulatory improvements being worked on by SBA, are what is needed to send a clear message to private management teams and private investors that the government truly does support the debenture SBIC program and wants to see it grow in effectiveness and helping to finance America's small businesses. Without them, we fear that the SBIC program will be marginalized over time. That is not a happy thought for a program that has been so important to the growth of American business.

Thank you for your consideration of our views. We look forward to working with the Committee as you finalize this important legislation.

ChairwomanVELÁZQUEZ. Thank you, Mr. Mercer.

[The prepared statement of Mr. Mercer may be found in the Appendix on page 85.]

ChairwomanVELÁZQUEZ. And now I recognize Mr. Michaud for the purpose of introducing our next witness.

Mr.MICHAUD. Thank you very much, Madam Chair.

The next witness is Ron Phillips, who is president and founder of Coastal Enterprises, Inc., a nonprofit community development corporation and community development financial institute based in Wiscasset, Maine. CEI works primarily in rural regions, creating jobs, affordable housing, and social services for people and places left out of the economic mainstream. CEI has also mobilized over $1.1 billion for financing and technical assistance in the development of small, medium and micro-businesses. Under its venture capital funds, CEI is making investments outside of Maine as well in northern New England, upstate New York, and other regions.

I want to welcome Ron here today, look forward to your testimony. And you also have 5 minutes. Thank you.

STATEMENT OF RON PHILLIPS, COASTAL ENTERPRISES INC., WISCASSET, MAINE; ON BEHALF OF THE COMMUNITY DEVELOPMENT VENTURE CAPITAL ALLIANCE

Mr.PHILLIPS. Thank you very much, Congressman, for your support. And that helps me with some of my time. I also want to thank Chairwoman Velázquez for inviting me to this hearing, and recognize as well Congressman Chabot, who also represents a new markets venture capital fund, which is one of the six funds that I also am representing here today, CEI Community Ventures, Inc. I also am a co-founder of the National Community Development Venture Capital Alliance, and was on the board. And that is a trade association for community development venture capital funds which are socially targeted, getting capital to small businesses, particularly small-scale capital in rural as well as urban regions.

I do want to recognize and acknowledge, too, Congresswoman Moore, because I know this manufacturing issue has come up as

to targeting more, because we have lost so many jobs overseas. And I have been very proud to say our industry, the community development venture capital industry, can count about 53 percent of its investment in manufacturing firms in the markets they are working in. In our own case we count about 77 percent. So we have got a vast majority of our investment going into manufacturing.

I am going to feature one story as I come to that. I have written comments. I have presented some of the recommendations in them, and I will get to them.

But I want to get to the heart of this matter. We have worked with Angel investors, I would like to say, as well as institutional investors. And there is some promising opportunities to get into the Angel network. We have raised, in our new markets venture capital fund, for example, we have invested a small, but very powerful $5.8 million. Very small. Our average investment is about $700,000, much smaller than the average in this country. We want to keep this in mind because we are getting to smaller-scale businesses that are just starting, need this capital. But that capital has leveraged up 26 million other dollars, most of it institutional dollars from banks and other places. We work very closely with banks, by the way, in our network. But interesting, $7 million has come from the Angel network that we work with for these companies. And I do believe that the relationship between the new markets venture capital company and the Angel network could be a very interesting place because we provide some of the formality of underwriting and screening deals, as well as the Angel networks, of course, bring their energy and passion to a particular kind of commitment. So I think there is some promise in there.

Let me give you one story, if I could. I didn't bring my clam chowder with me, but in Whiting, Maine, a population of 2,200, there was a company there called Look's Gourmet that was there for 100 years, a kind of a dormant company doing its thing, processing—the canning industry, which has been a prominent industry in that part of the State. Washington County, by the way, is the poorest county in Maine, as the Congressman knows, and it also is the first county in which the sun rises in America. It has those two features to it. So if you are ever there or travel there, keep that in mind.

But Mike Cote, an entrepreneur, he used to work with Pepperidge Farms foods, knew a lot about food processing, he is in his fifties, looking for an opportunity, a Maine native, an entrepreneur, bought the company and moved up there with his significant person, and they took it—they have begun the process of taking this company forward. We have invested in it. We put operational assistance funds to it to help it in the business planning and marketing, and particularly the branding of this company. It is called the Bar Harbor brands. You can Google that and buy often and buy plenty if you would like. The company now employs 26. It has doubled its employment from 11. That is huge in a place like Whiting, Maine, with 2,200. And if you read the Ellsworth American, you will see and hear the bylines, entrepreneurial spirit hits that town. That is what New Markets Venture Capital company is all about. They are setting the stage, they are creating the economic framework to help these companies go forward.

Now let me just end with some of my recommendations, and I have got many more ideas to offer if any questions come my way. The technical fixes are already incorporated in this. I just want to draw your attention to them. First, we recommended that the new markets venture capital become compatible with the new markets tax credit in terms of geographic regions and targeting. There are some details in there that if it does become more coterminous with the new markets tax credit, then we have now blended and made more efficient this program. That actually is the most important feature to this.

We also have asked for more time to raise capital. It is very hard to raise capital. We want 2 years. And we have also asked for actually no matching funds to the operational grant program. The reason why, although I agree that it is important to get States and others to match funds, places like Maine, and States, and States' budgets are really pressed, and hard-pressed, and rural areas are hard-pressed to come up with anything. So 10 percent of the total capital or up to $1 million of grant money will really help smaller businesses get off the ground.

Thank you very much. I would be glad to answer any questions.

ChairwomanVELÁZQUEZ. Thank you, Mr. Phillips.

[The prepared statement of Mr. Phillips may be found in the Appendix on page 92.]

ChairwomanVELÁZQUEZ. I would like to address my first question to Dr. Atkinson. Administrator Preston's testimony suggested that the SBA debenture-based programs are adequate to fill the need for investment for startup and early-stage small businesses. Would you agree with this assessment?

Mr.ATKINSON. I would not agree with that, because while I think they are an important step, I think two things are problematic. One is that the deals, as I said, have moved up even in SBIC to bigger deals, which I think was not the purpose of the program initially. And so I think your legislation to move it back is filling an important gap. If you are a big company—if you are a company that wants a $20 million or a $100 million dollar investment and you have got the right financials, you can get it. You can get it no matter where you are.

One of the key things about the way a lot of these investments work is you have to be within driving distance. So if you are not near that—so I think that is why—and I don't think the current programs work as well as they should, and I think the addition of an Angel program gets even more directly into that market gap.

ChairwomanVELÁZQUEZ. And that was my second question.

So, Dr. Koenig, in his testimony Administrator Preston expressed concerns that this bill would have the effect of permitting large businesses to receive investment funding intended for small businesses. Is this a legitimate concern?

Dr.KOENIG. I absolutely disagree that is a concern. All we are trying to do is fix this definition. The size of the company, all those provisions are all still maintained in the rulings. The fact of the matter is that the venture capital business is, while investing in the companies, the companies themselves operate the business. So they really—individually there may be a number of venture capital-

ists who actually invest in a business, but their actual ownership position in the company is only a small portion of the total company. So we don't see that this creates any risk for the businesses.

ChairwomanVELÁZQUEZ. Mr. More— thank you, Dr. Koenig—in your testimony you mentioned safeguards contained in the bill that will prevent the venture capital provisions in the bill from being exploited by large businesses. Can you comment on what those safeguards are and whether you believe they go far enough in protecting the interests of small businesses?

Mr.MORE. I don't know that I am knowledgeable enough to comment on that, but certainly when you have a company like Merck that sets up a venture capital operating company, Merck is—as a company is larger than 500 employees. And you know, we see corporate venture capital going on all the time. I would say that is an issue that I would see addressed by that.

ChairwomanVELÁZQUEZ. And Mr. Phillips, Administrator Preston stated that with LMI debentures, the SBIC program can actually provide greater investment to businesses in low-income areas and at less cost than new markets venture capital companies. If this is true, what additional benefit does the new markets venture capital program provide that the SBIC program does not?

Mr.PHILLIPS. I think that is a very good question. I don't think I agree with the Administrator on that, and I have discussed that with him. The SBIC, first of all, its average investment is much larger. And I have already made the point that we are dealing with smaller-scale investment capital for starting, seed, and early-stage companies. So that is one difference.

The second is the SBIC does not get involved on a hands-on technical basis with consistency with their portfolio companies. I am going to make that blanket statement. I am sure there are some SBICs that do very well that way, because part of the structure of a venture firm is to actually engage directly with a portfolio. But we get involved much more intensely with that, using the operational grant funds as an assistance to bring in specialized people to help with business plans, marketing, Web site, branding, and so forth development. Those are some of the things.

The third reason is that we target to geographic areas. I think SBICs, many of them do a great job, are not necessarily in the business of targeting, let alone socially targeting. We often target to environmental as well as social benefits and job creation. So those are some of the distinctions I would point out.

ChairwomanVELÁZQUEZ. I guess you saw the exchange between the Administrator and myself regarding the new markets program.

Mr.PHILLIPS. Yes, I did.

ChairwomanVELÁZQUEZ. Even though he says that SBA intends to continue supporting the new markets program, it is simply too early to provide additional funding for the program. What effect is this wait-and-see approach having on small businesses that participate in the program?

Mr.PHILLIPS. I have an answer to that, actually, and he would understand this. And I would love to talk with him directly about it. When you are involved in venture capital in setting up funds and operating funds, you need to maintain your continuity. And if you wait until one fund is completely in, or the jury is in, and you

haven't started the process to fund or develop your next fund, you are probably going to have a gap. And that is not a very good thing in the venture market if you have a team in the region and doing your work. So you have to start something. You have to put something in motion. You may not want to go into the particular project that is coming along, but you should at least get something going. And I would answer it at least that way.

ChairwomanVELÁZQUEZ. Mr. Mercer, Administrator Preston expressed concerns with the provision of the bill that will increase the maximum leverage limits for funds that invest in socially and economically disadvantaged small businesses. In your opinion, will this initiative restrict the investment decisions of SBIC licenses?

Mr.MERCER. No. I would disagree with the Administrator on that, because the way—the important thing for a fund, be it an SBIC or any fund, is to have the ability to have a diversified portfolio to spread risk on the portfolio. And I think the way that provision is drafted would allow for a diversified portfolio to spread the risk.

So, you know, the SSBIC program was a completely targeted program, and perhaps to too narrow a niche, where 100 percent of investments had to be in minority-owned enterprises. And SSBICs still exist. There are still I think 17 or 18 of them. But the fact is they are not—they are not raising additional capital. So it could be that even they are finding a too structured market too severe. So I think it is worth trying. You never know until you do try. And since it is such an important goal of Congress and most administrations, I would support it.

ChairwomanVELÁZQUEZ. Thank you, Mr. Mercer. Now I recognize Mr. Chabot.

Mr.CHABOT. Thank you very much, Madam Chair. Mr. Peterson, I think I will begin with you if I can.

Mr.PETERSON. Thank you, sir.

Mr.CHABOT. Have problems in the credit market affected the financial capacity of sureties to write bonds?

Mr.PETERSON. Not at this point; no, sir.

Mr.CHABOT. Do you anticipate that anytime in the future, or does that seem to be not something that is on the horizon?

Mr.PETERSON. You know, it is something that we are certainly conscious of. Anytime that the market undergoes some challenges it can have an effect on all of American businesses. But we don't really anticipate it having an effect on ours directly. We are an industry that is really tied to the business cycle. As the business climate improves and as economic activity expands, you know, our business improves and our activity expands as well. And conversely, when it contracts, the same thing happens to our industry. Credit markets obviously have a role to play in that, but they are not necessarily a significant determinant effect.

Mr.CHABOT. Thank you.

Mr. Atkinson, I will go to you next. Are tax policies such as research and development tax credits and lower capital gains taxes just as important, or many would argue probably even more so, to the development of a venture capital industry as government contributions of actual capital? And if so, how does that work out of the scheme of things?

Mr.ATKINSON. I would agree with you that they are just as important, in fact maybe more important. I absolutely agree. I think for example the R&D tax credit, we just issued two reports on that which are on our Web site that show fairly conclusively, looking at academic research both in this country and around the world, that tax incentives for R&D are very effective and do fill a need.

And by the way, I would add we used to be number one in most generous R&D tax credit in the world in 1990, and now we are number 16 among OECD nations. So I agree with that. I guess I just wouldn't look at it as an either/or. I certainly agree with you, though.

Mr.CHABOT. Thank you.

Mr. Mercer, if I could turn to you next. And before I do, just kind of an observation. You mentioned some of the companies that have benefited in the participating security SBIC. One of them was Build-a-Bear. And many of us who are parents have maybe had that experience. I know if you are in Gatlinburg or Myrtle Beach, you can't pass one of those places without your kids wanting one, even if they have them in the past. They play with them for about 5 minutes until they see the next Build-a-Bear site, and then want another one. Also they have the—you know, once you get the bear that is not the end of the story. That is just the beginning, because then there is clothing for all these things. And try to convince your kid that their existing doll clothes will fit the Build-a-Bear. It has to be the new stuff. What a racket. But they have done very well.

Mr.MERCER. It is just a legal pyramid scheme.

Mr.CHABOT. One that has worked quite effectively, at least in my house. But in any event, the real question, the bill we have somewhat talked about, although I don't think it has been completely pulled together yet but it is still being considered, that offers increased leveraged availability to women-owned and socially disadvantaged small businesses. And are the current incentives for making capital available to these small businesses sufficient or insufficient? And how much will this help to increase capital available to those specific type of businesses I mentioned?

Mr.MERCER. Well, let me start by saying that SBIC funds, indeed almost any venture fund or mezzanine fund, start with being gender-blind and ethnicity-blind. Most organizations don't even track the deals that they review, and they review hundreds if not thousands of potential deals each year, by whether the company is owned by a woman or a minority. So in the past, obviously with the SSBIC program, the government created a program that said, okay, if you want the benefits of a particular government program you must target 100 percent. And that program was terminated by Congress in 1996 because it simply became too expensive. The program was losing money. And so people have wrestled with this issue for years and not been able to come up with any good way to solve it.

Clearly, I think the biggest problem is that business plans that might merit funding often don't get to the desk of an SBIC manager or any venture manager. And it has more to do with the networks that are involved and how those business plans get there than anything else. The approach that is suggested in the draft legislation says that more money will be available to an SBIC if it de-

cides to agree to focus up to 50 percent, at least 50 percent on women- and minority-owned businesses. Will it work? I don't know. But by offering an incentive of additional capital it may work. And I think that as long as it is not—doesn't require that the fund focus—that the portfolio be so focused that it becomes too risky, I think it is perhaps a good experiment to try.

Mr.CHABOT. Thank you.

Mr. Phillips, if I could go to you next. You had talked briefly about some of the investments made by Coastal Enterprises and the success that you had, particularly in more challenging areas, some of which are in my district, for example. Could you just discuss a couple of those again to tell us the type of areas that are benefited?

Mr.PHILLIPS. Yes. Thank you for that question. We have a diverse portfolio. In terms of venture capital, we have actually invested in about 40, 45 companies in that portfolio alone, and then overall about 1,700 small businesses throughout the State of Maine and to some extent rural New England and upstate New York. So we have quite a range. Most of our investing is sub-debt capital, not venture capital but sub-debt capital, which is near equity in many ways. It is a debt instrument.

Our portfolio of companies are very diverse. We include child care centers, for example. But we will get involved with the fishing industry and fish processing, the farm sector and the timber industry. So a lot of it is natural resources. And these all have their challenges. They are all assets, however, to local and rural development, which is the way we approach these—our area.

We also are working more closely with new immigrants and refugees that are coming into Maine. Maine has been a very white State, but we are also working in that area. And we do a lot of micro-enterprise lending.

Now if we go down our portfolio and look at the character of it, I mentioned earlier most of it is manufacturing. A lot of it is in food processing, and naturally so, because you are in a rural area. That gets you into the concept of what a cluster industry might look like, if you invested more and more in the food processing sector. And that is going on not just in Maine, but in other parts of the country, as the consumers become more conscious of diet and natural and wholesome foods or organic foods. This is some of the character of our activity. Throughout that entire process we are looking at the job quality that gets created.

We are very concerned about health benefits and the challenges, too, that businesses face in paying into health insurance programs. But livable wages and job quality are important. And we are also trying to back women in business, and run a very robust Woman in Business Development Initiative out of our organization.

Mr.CHABOT. Thank you very much.

Madam Chair, in the interest of giving the other members that are here a chance to ask questions, I will yield back.

ChairwomanVELÁZQUEZ. Thank you. Mr. Michaud, you have any questions?

Mr.MICHAUD. Thank you, Madam Chair. I have one question for Mr. Phillips.

Dealing with the manufacturing businesses, as you know the Committee has set aside a portion of the new markets venture capital appropriations to companies that are primarily engaged in the development of and investment in small manufacturing. And I would like to know what percentage of CEI's investments go to small manufacturers? And how do you determine what type of business to invest in? And do you focus specifically on certain sectors?

Mr.PHILLIPS. Oh, boy. Thank you. I almost think I answered some of that before, but I will try again.

Most of our portfolio is in manufacturing. So that is a good sign. I understand there is some language in the bill around this. And I get a little bit conflicted exactly how to do that, because I know in venture capital you have got to be flexible and be very careful about narrowing one's options in a fund, because you can get into some difficulty with that.

At the same time, we are very sympathetic with the concept of manufacturing. My view is that different regions of the country have different assets and potential. So as much flexibility as possible ought to be in there. And already I think a lot of the funds, at least that I represent, are investing in manufacturing.

How do we determine that? You are looking at what the competitive advantage is of your region. In Maine's case, I just mentioned the food processing sector. We also have energy, timber industry. As you well know, in different aspects of the timber industry. So you are looking to align capital with the competitive opportunities that exist within the actual geographic region you might be working with.

Mr.MICHAUD. Do you think agencies, whether it is EDA, SBA, should be looking at—if they are going to invest, put money for economic development opportunities—they ought to look at clusters and that a certain portion of funds should be promulgated that the fact that they can get actually private sector funding in them?

Mr.PHILLIPS. I think cluster, some here might know more about that as a development strategy than myself, but I think cluster industries concept as a development strategy is not new. It has been around. There is a lot of a body of evidence and evaluation to show it is a very important way to do economic development in any particular region. There is a lot of networking.

That Look's Gourmet, by the way, is in the food processing sector. But also the interesting thing is the mussels, and lobster shells, and clam shells that they produce as waste are bought by—are delivered to a local crafts person in Washington County who turns those into flatware, silverware for your dinner table. So you have very colorful sorts of things there. There are a lot of spin-offs around industry. And that is part of the image of what you are trying to do is create new synergies at that regional level. Thank you.

Mr.MICHAUD. Thank you very much.RPTS DEANDCMN NORMAN

Mr.MICHAUD. Thank you very much.

Mr.CHABOT. Let me ask one question. In your opinion, Mr. Mercer, what is the best way to get equity to small businesses? Is it best to create new programs or improve existing programs, if you have an opinion?

Mr.MERCER. Thank you very much for that question, to quote the former Administrator of SBA. I might want to take a pass, but I will wade into the waters. There are two distinct things. You know, equity investing in this country is a continuum from family and friends and then Angels and then into more institutional and larger fund sizes. You essentially cannot have—if you remove any of the pieces of this capital markets continuum that has served our country so well, or if gaps form in any of those, then the country is ill-served. I am not in expert on Angel investing and so I would not want to say that the provisions in the draft legislation are not a good way to increase equity financing for small business because it presumably would increase equity financing for small business.

I think the participating security program showed itself, at least in the early stages, the first several years, to be a very good vehicle for stimulating equity investing as well; although what I would say is that the size of those investments would probably be larger than the size of the typical Angel investment and would be at the next stage of investment.

So you could go back and improve—you could resurrect the participating security SBIC program, literally by putting a provision in the Small Business Investment Act that says for the provisions of the Fair Credit Reform Act, for the purposes of the Fair Credit Reform Act, a participating security is a debt security for all purposes, and that would solve the problem.

From an accounting standpoint it is a debt security. SBA requires the participating security funds themselves to carry it on their books as a debt security. It is only OMB who said it is not a debt security for the purposes of the Credit Reform Act. So you might want to improve the program by focusing it towards more early stage or—and you would still have a credit subsidy problem that might carry a subsidy rate of 24 percent. So there are things you would have to do to solve it.

But I do not think the two programs are mutually exclusive. I do not think that is the case. I do not want—I guess that is my answer.

ChairwomanVELÁZQUEZ. If I may, Mr. Mercer, but you know also the changes that you will want to see for the program will have to be supported by the Budget Committee, and they are not willing to do so.

Mr.MERCER. I understand that CBO— well, the participating security program exists in law right now and new leverage could be provided as long as it was on a dollar-for-dollar appropriation. Clearly that is not going to happen. The program will not ever exist unless it is a credit subsidy program. In order to get to be a credit subsidy program, the security has to be considered a debt security. Right now it is not.

Mr.CHABOT. Reclaiming my time.

ChairwomanVELÁZQUEZ. Sure.

Mr.CHABOT. Mr. Koenig, if the capital community—assuming it is very astute in evaluating the market potential of a firm—and it does not make an investment, should that not be an indication perhaps to the government that it should not make an SBI or award?

Dr.KOENIG. Not at all. As Mr. Atkinson was pointing out, the way the venture capital community has funded the biotechnology

industry has evolved over time. In the early nineties there was a lot more opportunity for companies at an earlier stage to get to the public markets. Companies that had less developed programs could put out public offerings to get other access to capital.

What has happened since the year 2000 is that much of the venture capital money is going to later-stage opportunities. And so because it has taken a lot more money to develop any more programs and get to the public markets, they have taken most of their opportunities and focused it on these late-stage opportunities, which is now creating a much larger gap. So their rejection of this is not for the merits of the science. The science typically in most of those cases is too early, not developed, and they would have to invest so much more money before they would see a return on their investment the way these companies are set up right now.

Mr.CHABOT. Thank you.

Mr. More, what economies of scale and scope are available to venture capital firms that are not available to small businesses that do not have venture funding?

Mr.MORE. I am not aware of economies of scale. Do you mean two companies using the same manufacturing facilities?

Mr.CHABOT. Venture capital firms—in other words, having access to a better situation than would individual companies, for example.

Mr.MORE. I think the venture capital industry, venture capitalists themselves, we talk a lot about how we try and help our companies. I think, honestly, some of that is true. Some of that is rhetoric as in any other industry. I don't think grouping venture capital firms together as a class and saying just because something is venture-backed, first of all, does not mean it is a good idea and it is going to be successful.

Second of all, there is a spectrum of venture capital out there. You have $10 million funds that are venture capitalists that are trying to invest in minority areas. A friend of mine, Tom Darden, is doing that in Detroit. There are big funds that are large international institutional funds that are investing hundreds of millions of dollars that may have economies of scale that I am unaware of.

I do not see any of that in the biotech industry. We may say that we have used this consultant on occasion and we will use them in new companies we are setting up. And if you call that an economy of scale it is not like we are getting a better deal. The one validation is we have used them before and we know they are a good person to work with. So I think the networks are important, but I do not think there is any economies.

Mr.CHABOT. I yield back.

ChairwomanVELÁZQUEZ. Ms. Moore.

Ms.MOORE. Thank you so much, Madam Chair, for recognizing me. I want to thank you for this really important hearing on SBA's investment in surety bonds programs. I am very, very excited to be here today because I do think, I do agree with our distinguished panelists that this is really the appropriate role for government to leverage our few little dollars with the needs of the business community, because you indeed do create opportunities and jobs.

Just a little commercial to those in the biotech venture capital business. Wisconsin has the most important line—or the—of stem

cells. So make sure that the geographic distribution of those funds recalls our industry in Wisconsin. So I'm done with the commercial.

I just want to ask a few questions. I do not know who the appropriate person is. Perhaps Mr. Phillips. I am particularly interested in Title II of this bill, the new market venture capital program. As the Chairwoman knows, ever since I have been on this Committee and been a Member of Congress, I have tried to get the new market venture capital program up and going, and hopefully with—I am so happy this is part of this package, as I have introduced this bill both sessions that I have been here.

Mr. Phillips, I wanted you to clarify your comment about getting this in sync with the new market tax credit program, because I thought we had done that. If you could specifically—this is a technical question.

Mr.PHILLIPS. It is technical. In my comments I gave the technical language to describe the technical ways in which this needs to happen. It has to do with a couple of things. The new market tax credit and the new markets venture capital programs came into being in the Clinton administration, and they disconnected in the wee hours of some morning in terms of their consistency and compatibility. So that is all that is being talked about, just for the record, is to make the programs consistent in terms of geographic areas that qualify in terms of census track eligibility. So it gets down to census track, and the new markets venture capital does not quite overlap with the new markets tax credit, so we are trying to get it to just qualify, at least on that census track basis.

The second thing we are trying to do is make some exceptions to geographic eligibility by allowing for investment in projects outside the eligible census track so you are now looking at targeted population. The CDFI has a ruling on this it has published on how that all works. So we are trying to do that.

Now, why is that? Particularly for rural areas, but also urban areas, you can have a project that just is outside the census track, as a distressed census track right across the street, and literally you cannot do that project. A manufacturing facility could be across the street in Madison where it does not qualify. Under targeted populations, you could do that. I could go on and on.

Ms.MOORE. Well, that does lead to my next question. Senator Kerry, we were working with him on the reauthorization of this bill, and he did raise these points. Our concern then was that the language would be tight enough so that it could not be construed as some amorphous doing good things for low-income communities, like having some indirect impact on low-income communities; i.e., you have hired all the greeters for Wal-Mart out of a certain census track and you have invested in an entity that was not there. So I hope that the chairperson and others will work with you on this, because that was my concern is that it would be just too flexible.

As it relates to the statutory purpose of providing economic development in low-income areas, I would hope that these changes would not take this off of this initial mission.

Mr.PHILLIPS. I do not think they do. I think the targeted population is very difficult to apply in the real world, I give you that. I am a practitioner—representing that right now, a national organization. It is hard to apply target populations, actually, due to the

fact that it is not flexible. It is really right on in terms of making sure low-income people benefit. It is very hard to do.

I do have one thing to say about the new markets tax credit, if I could offer this.

Ms.MOORE. Yes, yes.

Mr.PHILLIPS. This Committee—I put this on the table. You asked the question, so what is the best way to deliver equity capital? You know the new markets tax credit has been a phenomenal success as a model in using the tax code to spur private capital investments and large investments into places it has not traditionally gone—in rural communities this has been exceptionally important— tens of millions, and now in the billions of dollars flowing into projects, very interesting projects, to revitalize a communities that have never seen this kind of capital before as a result of the Tax Code and tax credit.

If we were to find a way to really make the tax credit work for the venture capital industry—and there are some technical barriers to that, which I could take a week going through with you—then you have really opened up a whole new world of getting the experts of venture investors, who are really good at analyzing and understanding the future. At least they know how to make bets.

So I offer this, and there is some good work that needs to be done—we have talked to Administrator Preston about this—the CDFI fund and the U.S. Treasury need to get involved. There are some financial models, but you need the will to make this happen.It is not that easy.

Mr.ATKINSON. I wonder if I could beg the Committee's forgiveness and ask to be excused. I have a speech I committed to give.

ChairwomanVELÁZQUEZ. Sure. I am about to adjourn. I want to thank all of you. You have been a very good hearing today on this important subject. We will continue to work together to clarify some of the concerns that have been raised. And the gentleman has a unanimous consent request?

Mr.CHABOT. I do. I just ask unanimous consent that a statement from Mr. Graves be admitted into the record.

ChairwomanVELÁZQUEZ. Without objection.

ChairwomanVELÁZQUEZ. I would like to say that I ask unanimous consent that any statements submitted for the record be accepted for 5 legislative days. This hearing is adjourned.

[Whereupon, at 12:43 p.m., the Committee was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velàzquez, Chair
House Committee on Small Business
Hearing to Consider Legislation Improving the SBA's Investment Programs

I am pleased to call this hearing to order.

In today's hearing, the Committee will examine a proposal to improve the Small Business Administration's existing investment programs and establish a new Angel Investment Program. These enhancements, which expand access to venture capital, will help modernize the SBA so that its service-offerings meet the needs of America's entrepreneurs.

In June, this Committee received testimony from key members of the investment community who described the challenges facing our nation's small businesses. Small businesses rely on venture capital investment to fund their pursuit of new ideas. Indeed, many well known companies began as small businesses that grew to prominence with the help of venture capital.

Several companies like Google, IBM, and Microsoft would not be the industry leaders they are today if it were not for venture capital investment. Yet, despite this importance, it remains extremely difficult for small businesses to attract investment. This is particularly true for two key segments of the business community – early stage businesses and those located in low-income areas.

Over the last five years, there has been a steady movement of venture capital away from small business startups and toward later stage businesses. This has not only limited the ability of small businesses to expand and grow, but also has hindered their ability to generate innovative new ideas and new products. Venture capital represents the lifeblood for these businesses, and without it, these startup companies will never reach their full potential.

Perhaps no federal agency is better positioned to address these problems than the SBA. Unfortunately, the Administration has failed to press these advantages for the benefit of the small business community. It continues to withhold the support necessary for the New Markets program to achieve its full potential. Similarly, SBA has failed to explore new strategies that have proven successful at increasing venture capital investment in startups. And, perhaps most notably, the agency continues to follow outdated policies that restrict the flow of venture capital and other forms of investment to small firms.

The Committee Print being considered will begin to reverse these policies. This proposal would renew our commitment to increase investment in low income areas by restoring funding for the NMVC program. It also features a renewed focus on small manufacturing companies, providing much needed help to communities that have suffered from a loss of their industries.

A new Angel Investment Program would also be established. This would fill the void for seed capital that has been created by the elimination of the Participating Securities program. This emerging strategy is already enjoying widespread success in the private sector and will be a vital step in ensuring that startup and early stage businesses have the capital they need to grow stronger.

The proposal will simplify and streamline the treatment of small businesses receiving venture capital investment. This change will ensure that entrepreneurs have unimpeded access to this key form of financing. Together, these initiatives will strengthen the SBA's commitment to improving investments in small businesses and dramatically improve innovation among our nation's entrepreneurs.

Our small businesses have always been the incubators for new ideas – and investment has been the fuel for this great engine of American economic development. As this country continues to rely on entrepreneurs to spur economic development and create jobs, the need for equity capital will only continue to grow.

I would like to extend our thanks to all of the witnesses who will be testifying today. I am sure that their unique view and comments on the proposed legislation will be insightful as the Committee moves forward in the legislative process on this very important subject.

I now yield to Ranking Member Chabot for his opening statement.

Opening Statement

Hearing Name	A Hearing to Consider Legislation Updating and Improving the SBA's Investment and Surety Bond Programs
Committee	Full Committee
Date	9/6/2007

Opening Statement of Ranking Member Chabot

I would like to thank the Chairwoman for holding this important hearing to address legislation that will update the Small Business Administration programs that provide long-term capital and surety bonds to small businesses.

Recent events in the financial markets show that small businesses will continue to face difficulties raising credit and capital through normal commercial markets. Those business owners with solid credit scores and balance sheets will have to spend more to obtain credit. Those without such stellar credentials may find credit and capital very scarce. Such gaps in the commercial finance markets are problematic because small businesses are the most significant component for creating new jobs in the economy. An economy that faces some uncertainty due to problems in the housing market will have the situation exacerbated by any limitations on small business growth resulting from restrictions on availability of capital.

During the past six years, this Committee has heard from a variety of sources that conventional debt and equity markets do not provide adequate resources to small businesses, particularly new small businesses – ones that do not have track record of cash-flow and solid earnings. The Committee already has passed legislation that addresses improvements in the market for debt. Today, the Committee is considering legislation to rectify issues in the equity markets for small businesses.

Some of the changes proposed in the legislation we are considering today are appropriate and necessary technical changes. For example, special small business investment companies called new market venture capital companies are hampered because the definition of new markets in the Small Business Investment Act is more restrictive than the one in the Tax Code. It certainly makes sense to modify the Small Business Investment Act to improve the capabilities of new market venture capital companies to invest in poor areas.

Another appropriate technical change involves raising the limits on the amount of leverage available to small business investment companies rather than using an index for inflation. This change will provide these SBICs with greater certainty concerning the amount of funds that will be made available by the SBA.

These and the other technical changes in the bill to improve the existing equity programs make sense. However, I am not yet convinced that we need to create

completely new programs to provide equity capital to small businesses rather than continue to tweak existing programs. I will be very interested in hearing from our witnesses their views on the best approach that the Committee can take to ensure that small businesses have access to equity capital given the recent tumult in the financial markets.

The other program that we are examining today is the SBA's guarantee of surety bonds. Surety bonds generally are required to assuage the buyer of services that the supplier will finish the contract or some substitute will be found to do so. Surety bonds are used in many industries, although they are most prevalent in construction contracts. If a contract requires a surety bond, small businesses, particularly one without a significant track record may not be able to bid because the business will be unable to obtain a surety bond at a reasonable cost. The SBA surety bond program then provides an important tool to increase the competitive capacity of small businesses to bid on various contracts, including those offered by the federal government. The technical changes that we are considering for the surety bond program will enhance its availability and utility for small businesses. In turn, an improved surety bond program will enhance the competitive capacity of small businesses to win contracts that require the proffer of a surety bond.

Finally, the bill makes drastic changes to the definition of small business by eviscerating the long-held standard that a small business is one that is "independently owned and operated." Title V of the bill we are considering will enable venture capital companies to own, control, and operate numerous small businesses without any affiliation standard at all. This will enable venture-funded small government contractors to take advantage of economies of scale and scope that truly independent small businesses will not. In the long-run, this will reduce competition in the government marketplace and increase costs to the taxpayer. I am willing to hear what advice our witnesses will have on reducing the potential significant adverse consequences on small businesses of this change.

Again, I would like to thank the Chairwoman for holding this hearing and look forward to the ideas offered by our distinguished panelists.

I yield back the balance of my time.

Statement of the Honorable Jason Altmire
House Committee on Small Business Hearing
"A Hearing to Consider Legislation Updating and Improving
the SBA's Investment and Surety Bond programs"
September 6, 2007

Thank you, Chairwoman Velazquez, for calling today's hearing and for your continued work on behalf of America's small businesses. I appreciate your leadership and the opportunity that I have had in working with you and the committee staff in drafting legislation to improve access to equitable capital for America's small businesses.

The previous hearing this committee held on June 21 examined many of the challenges that small businesses face in acquiring investment capital: high levels of risk, regulatory and compliance costs, the cost of capital assets and limited cash-flow, to name a few.

The primary source of investment assistance through the SBA is the Small Business Investment Company (SBIC) program. It is a public-private partnership that has invested $48 billion in more than 100,000 small businesses since 1958. Notable success stories include Intel, Apple Computer, Whole Foods, Staples, Quiznos, and Costco.

The SBA's other two investment programs – the New Markets Venture Capital (NMVC) program and the Surety Bond program – have, however, demonstrated minimal success. Only six companies currently participate in the NMVC program and the Surety Bond program has become an increasingly unattractive option for small businesses.

All three of the SBA's investment programs are designed to provide our nation's small business startups with access to equity capital in order to foster innovation and create more jobs in our communities. Unfortunately, these programs have fallen short, creating an environment where it is difficult for startups to attract investment.

Today we have an opportunity to discuss how to address these challenges and begin consideration of a legislative solution that I will soon introduce – the Small Business Investment Improvements Act of 2007.

My bill will streamline the Small Business Investment Company (SBIC) program, expand the New Markets Venture Capital (NMVC) program, improve the Surety Bond program, and establish a new Office of Angel Investment.

The changes my legislation proposes to the current structure of the Small Business Investment Company will bring it up to date with today's practices. It simplifies how the maximum leverage caps are calculated and revises the limitations on aggregate investment to increase overall investment in small business. Further, it will provide incentives to target investment to businesses owned by veterans and women.

Changes will also be made to the New Markets Venture Capital program by providing incentives for investments in small manufacturing companies in low income areas and expanding the program. Doing so will ensure a wider distribution of investment nationwide and create opportunities for more small businesses to advantage from the program.

Finally, my bill will establish an Office of Angel Investment that will focus on increasing equity investment in small business. Within the new Office of Angel Investment, an Angel Investment program will be developed to match angel groups with early stage small businesses, placing priority financing with groups that invest in businesses operated by veterans or women. A Federal Angel Network will be made available through the SBA's website and a grant initiative will be established to increase awareness about the benefits of angel investing to both the entrepreneur and the investor.

The Small Business Investment Improvements Act reduces many of the barriers that small businesses face when seeking to obtain equity investment through the SBA and its private partners. Small businesses are the backbone of our economy, generating 57 million jobs a year. Ensuring that they are able to obtain vital capital at crucial points in their development is of paramount importance. I hope my colleagues will join me in support of this effort.

Madam Chair, thank you again for holding this important hearing today. I yield back the balance of my time.

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TESTIMONY

OF

STEVEN C. PRESTON

ADMINISTRATOR

US SMALL BUSINESS ADMINISTRATION

HEARING ON

LEGISLATIVE PROPOSALS FOR

SMALL BUSINESS INVESTMENT PROGRAMS

BEFORE THE

COMMITTEE ON SMALL BUSINESS

US HOUSE OF REPRESENTATIVES

SEPTEMBER 6, 2007

Chairwoman Velazquez, Ranking Member Chabot, Members of the Committee, good morning. My name is Steve Preston, Administrator of the Small Business Administration. Thank you for giving me the opportunity to testify on potential legislative changes to the Small Business Investment Company programs at SBA.

Since its inception in 1958 SBA's SBIC program has invested over $50 billion in over 100,000 small businesses, a record of over forty years of performance as part of the Nation's economy. The debenture program has formed the backbone of this investment and has operated without cost to the taxpayer, aside from administrative expenses, for the last seven years.

In 2006 alone, SBIC debenture licensees invested over $1.2 billion, and the SBA issued $400 million in further commitments. Currently, approximately 25% of debenture funding goes to Low and Moderate Income (LMI) areas, amounting to nearly $310 million in investments in LMI areas last year.

Despite these numbers SBA has continued to focus on making capital even more available to small business in low and moderate income (LMI) areas. SBA continues to reach out to our licensees and the venture capital community in order to target more debentures to underserved markets and help create sustainable economic growth in areas with the greatest need.

Over the past year the Investment division has developed and implemented an outreach plan dedicated to increasing our reach into the underserved markets of our Nation. This plan has the following primary objectives:

1. Attract qualified and appropriately structured firms.
2. Invest in "Emerging" Managers
3. Educate Potential Limited Partners: Institutions and Community Reinvestment Act (CRA) Investors

To accomplish these goals the investment division has developed, and disseminated improved guidelines for fund structures & strategies that improve the fit for LMI debenture leverage, and revised the Management Assessment Questionnaire (MAQ) to better suit these Debenture program applicants. They have also used SBIC internal data and outside sources (including the Urban Institute Study) to develop a marketing presentation geared toward attracting new fund managers and limited partners.

In December of last year the division hosted a symposium titled "Access to Venture Capital for Women and Minority Entrepreneurs" at SBA's headquarters. Key leaders in private equity and venture capital came to help SBA develop a plan to better serve the needs of women and minorities.

In the past year the Investment division has made presentations to members of the Executive Committee of the California Hispanic Chambers of Commerce (CHCC), senior officials from CalPERS and CalSTRS, The Institutional Limited Partners Association (ILPA), the National Association of Investment Companies (NAIC), the Alternative Investing Summit East and other venues with the specific focus on increasing minority participation in the SBIC program and increasing SBIC investment in underserved markets.

In addition, based on experience from a 2006 CRA event in Philadelphia, the Investment Division is working with both the Federal Reserve Bank and the Federal Home Loan Bank of Chicago to plan a Midwestern conference to educate CRA-focused entities about the SBIC Program and the potential investment opportunities amongst SBICs in formation. The division is also re-opening dialogue, through one-on-one meetings with the member banks of the Small Business Investment Alliance ("SBIA"), an association of large CRA oriented bank investors with a history of investing in SBICs.

SBA also continues to aid underserved markets through the New Markets Venture Capital program (NMVC) which has made over $47 million in equity investments in 55 portfolio companies over the last five years. To date, the New Markets Programs has created over 400 new jobs in addition to approximately 1,100 jobs retained in Low Income (LI) areas across fifteen states and the District of Columbia.

NMVC Companies (NMVCCs) have also provided over $10 million in operational assistance to over 170 actual and/or potential portfolio companies in their targeted geographic areas. While this program is unique in that the fund managers of NMVCCs receive grant funding to provide operational assistance to actual and/or potential portfolio companies to reduce the risk of investing in these nontraditional areas these dollars do not necessarily equate with success.

To date, none of our NMVCCs have repaid their debentures and the record of exits from investments is small. Despite five years of investing this amounts to only one sixth of the impact of one year of SBIC debenture funding in LMI areas, and licensees have not invested the full amount of leverage available. I should also add that the cost of this program is approximately 30 cents for each dollar invested, based on the combination of the operational assistance grants and the credit subsidy cost of the program.

Nevertheless, SBA intends to continue supporting and managing the New Markets program and we will assess the future potential of this program as investment results become clearer.

At the same time, a separate private equity funding mechanism –angel investing -- has been growing. This mechanism has always existed, but until the late nineties it received little public attention.

As the nation's economy shifted towards a more entrepreneurial economy, angel investing has emerged as a significant funding source. According to the 2006 report from the University of New Hampshire Center for Venture Research (UNH-CVR) the angel investor market is now 25.6 billion dollars, up 10.8 percent in the last year alone, and angel investing has been steadily growing since 2001.

While the angel investment market deserves attention as a source of critical seed capital for entrepreneurs, the Administration believes that stable pro-investment policies are a more effective method of encouraging angel activity than government programs. Over the past five years, angel investment has grown from $15.7 billion in 2002 to the current $25.6 billion, a 65 percent increase that has cumulatively created over 540,000 jobs in the last three years alone. (Source-UNH-CVR)

The Administration believes that the best way to strengthen this engine for small business is not through government involvement in its funding, but rather through creating an economic framework that encourages investment at all levels through broad based and reasonable tax rates, and reduced regulatory impediments to the flow of that capital. The Administration firmly believes that this economic policy has been a factor in the rebound of the angel investor sector after it fell from $30 billion in 2001 to $15.7 billion in 2002.

I would now like to turn to the draft legislation that has been forwarded to the SBA for comment. Let me begin with the proposals regarding the Debenture program.

DEBENTURES

SBA has no opposition to many of the proposed changes in Title I of the bill. We believe that these changes can help clarify certain unwieldy requirements in the current program without increasing risk to program performance.

However, SBA believes that either the current tiered structure should remain in place or the maximum amount of leverage be limited to two tiers. SBA has the regulatory ability to limit the tiers to two times regulatory capital, but we are concerned that licensees will view the statutory limit as an entitlement.

A third tier would increase the risk profile in the program and adversely affect subsidy costs. Many debenture funds receive current income and periodic returns of capital and have reinvestment capability thereby mitigating the need for a third tier.

SBA also believes that these changes should have little or no negative cost impact on the SBIC program. In fact, we believe that the less complicated rules regarding leverage and aggregate investment should encourage funds to look in the direction of the SBIC program.

SBA has some concerns, however, regarding Section 102 of the bill. We believe that the language targeting distressed communities and underserved rural and urban areas already in the Small Business Investment Act accomplishes the demographic effect desired. SBA is concerned with the possibility of unduly restricting the investment decisions of SBIC licensees through the inclusion of a "socially or economically disadvantaged" definition.

NEW MARKETS VENTURE CAPITAL

While the initial results of the New Markets program may appear promising, in terms of dollars invested, it would be premature to judge the program's overall effectiveness. The six NMVCCs are in the "investing" stage of their investment plans. To date none of the NMVCCs have been required to start making payments on their debentures, which have interest deferred for the first five years. Until the NMVCCs have started the "harvesting" stage of their life cycles and are required to make payments on their debentures, SBA cannot judge the individual performance of the NMVCCs or the overall performance of the NMVC program.

The goals of the program remain laudable, but the Administration has a legitimate concern that, in a situation where we have little or no repayment history, any changes or further funding would not be prudent. Furthermore, as stated above, the existing debenture program has an excellent record of investment in low and moderate income communities with nearly $310 million invested last year alone.

ANGEL INVESTORS

Turning now to the Angel Capital provisions of the bill the Administration believes the establishment of an on-line database for angel investment would be redundant; there are already at least four such websites in existence including the Angel Capital Association's. That information is a readily available tool for small businesses seeking financing.

Further, while the Administration believes in encouraging private investment in small business, we cannot support the subsidy proposed in the bill. Angel investing represents venture capital in its purest form – individuals using the capital at their disposal to foster business growth without the potential distortions and complexities involved in government intercession.

The draft legislation appears to have only a requirement that angel funds be "accredited" and have made investments, without consideration for the angel group's success at growing companies. Assuming that an "angel group" is actually an "angel investment fund" typically the angel investors comprising the fund are allowed to invest side by side. Further, the program structure presents a potential conflict. Because the SBA injection will be limited to $2 million per group, when portfolio companies require follow-on capital, the angel investors could potentially create deals allowing them to increase their returns at the expense of the SBA investment.

Angel investment is clearly equity funding, and because the draft legislation indicates that the government would only receive a share in the profits, if any, this provision would of necessity have a 100% credit score for funding purposes. However, I must point out that the draft bill does not indicate any repayment of proceeds should the investment not be profitable.

For example, suppose the private investors put in $1 million and used $1 million of Government financing, and ultimately the investment took a 50% loss, so that the total proceeds ended up at only $1 million. Under this proposed legislation there does not appear to be any return of the Government's share of the $1 million invested. What happens to the $1 million in proceeds? Does it all go to the angel investors? If so, in this example, the Angel investors would be made whole from the Government grant proceeds. (It should be noted that many unprofitable investments are not a 100% loss.) As shown in the example, the government capital could take the first tranche of risk and the angel capital could potentially be returned. In effect, the Government is giving money to accredited angel investors.

SBA assumes that the risk is to be shared *pari passu* but even so, it is not clear if the profit is calculated on the portion of the investment funded by the angel group or on the total investment including the government's share.

Some of the Administration's more specific concerns are:

1. Sec 381 (1) states that the angel group needs to be organized, but what is meant by "organized"? Angel investors are really just wealthy individuals. There is no requirement for competent investing or management expertise beyond the individual's personal success. Also, the experience mentioned in section 382 (b)(1) is not required to be successful experience.

2. Section 382 paragraph(c)(3) indicates that an angel group that receives financing under this section shall use the amounts received to make investments in small business concerns with "more than 50% of the employees of which perform substantially all of their services in the United States **as of the date on which the investment is made.**" This indicates that once a financing has been made, any employee growth can be offshore. If so, then this taxpayer money could be used to finance foreign employee growth.

3. Sec 382 (d) – It is unclear whether this limitation is for each investment made under (g) or is the maximum any angel group can receive. The SBA should not be in a position of limiting the number of groups an angel investor can belong to.

4. Sec 382 (g) – This provision requires that at least half of an investment come from the angel group. It appears that the government funds flow to the angel group which then invests them. If so, is the entire investment made by the angel group with half of the funds supplied by the government? These mechanics are important as any repayment (under Sec 382 (h)) may be affected.

5. Sec 382 (h) – This provision limits repayment to proceeds from profits. However, oftentimes, a fund may receive some return of capital but no profit. In that instance, should the government receive no distribution?

SURETY BONDS

The SBA welcomes the suggested improvements in the surety bond program. Over the last few years participation in the program has diminished and while SBA has made a number of regulatory and administrative changes, there is a limit to our ability to effect change without statutory authority. I am glad that our recent regulatory effort is working, but we acknowledge the need for legislative changes, for example the increase in the surety bond level from two million dollars to three million dollars. This statutory limit has not been increased since the program's inception and is a concern that has been raised to the Administration several times.

VENTURE INVESTMENT

SBA has only recently seen the language concerning ownership interests of venture capital firms in small businesses. While the SBA encourages venture capital investment in small business we must object to this provision. The basic premise of small business size status (independent ownership and control) is circumvented by the provision, which would allow a large business to own and control several small businesses without affecting the size status of the businesses. Furthermore, concerns wholly owned by large businesses could compete for and obtain contracts set aside for small business concerns, as well as grants and other forms of assistance reserved to small businesses. This also represents a potential conflict with our recent efforts to address the misidentification of large firms as small businesses for federal procurement purposes.

Chairwoman Velazquez, the SBA is working diligently to strengthen its impact through the investment division and its programs, but we have tempered those efforts with prudence. We have increased our oversight function to address problems we have faced in the participating securities program. At the same time, we have worked to improve our relationship with the industry and to reach out to industry leadership to address issues and concerns, and work toward common solutions.

The SBA is actively seeking industry input on making the SBIC program more attractive to both fund managers and investors, and we believe the debenture program can have a substantial, positive impact on the Nation's communities. However, we firmly believe that the best and most equitable way to influence investment in small business in all communities is through sound, broad based tax and economic policy that encourages investment at all levels.

Thank you for the opportunity to testify before the Committee today and I look forward to any questions the Committee Members might wish to ask.

Testimony of William G. Peterson
CNA Surety Corporation
Vice President and Public Affairs Officer

Before the U.S. House of Representatives

Committee on Small Business

September 6, 2007

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Madam Chairman, thank you for inviting us here today to testify on a matter that is critical to the surety industry, to the construction industry and to small and emerging businesses.

My name is Bill Peterson, and I am Vice President/Public Affairs Officer for CNA Surety. CNA Surety is the nation's largest publicly-traded surety and fidelity bonding company. Our corporate headquarters is in Chicago although my office is in Sioux Falls, South Dakota. We serve a full range of surety needs from the smallest commercial bond to multi-million dollar contract bonds. We have participated in the SBA Bond Guarantee Program since 1994. We are a significant writer of these bonds for SBA and were honored to be named by the SBA as its Surety Partner of the Year in both 2005 and 2006. On a more personal note, I served eight years in the South Dakota House of Representatives, four years as Majority Leader, where we also dealt on occasion with the issue of small and emerging contractors; so I have had the opportunity to see these issues from both sides of the table...that of a policy advocate and as a public policy decider. I am honored to have been asked to appear before you today as an advocate for the SBA's Bond Guarantee Program.

I am representing The Surety & Fidelity Association of America (SFAA) and the American Insurance Association (AIA), the trade associations that represent over 500 insurance companies licensed to write surety and fidelity bonds. SFAA and AIA members collectively provide the vast majority of performance and payment bonds on federal and state construction projects in the United States. The trades have discussed the issues regarding the SBA Bond Guarantee Program since its inception. My testimony here today reflects both the experience of the surety industry in general with the SBA Bond Guarantee Program, as well as the hands-on knowledge of it based on CNA Surety Corporation's participation in it since 1994.

The Surety Industry's Interest in the Funding and Activities of the Small Business Administration — The Surety Bond Guarantee Program.

Some History

Since the early 1970s, the SBA has operated the Program, which provides surety bond companies with partial repayment of losses from bonds that they would not ordinarily write for less qualified small and emerging contractors. The purpose of the Program is to obtain surety bonds for small and emerging contractors so that they can develop a track record of success. As these contractors grow and establish themselves, they then already have a relationship with a surety company. This surety company then can provide the bonds they need as government contractors, either with or without the SBA bond guarantee. The goal of the guarantee program is to graduate contractors into the standard surety market, making the guaranty funds available for new small and emerging contractors.

It is essential to understand why this is important. For most public construction projects, contractors are required to provide surety bonds to the government. These bonds guarantee that the contractor will perform the work and will pay the subcontractors, suppliers and workers on the project. Since the surety will be required to pay if the contractor cannot perform its contract and pay its bills, a surety carefully examines the contractor's capability, experience and financial situation when determining whether or not to put its own financial wherewithal behind the contractor. Establishing a track record and building capital is a challenge for small and emerging contractors. Therefore, in order to assist these small businesses to obtain work on public

projects, the federal government determined that it would act as a reinsurer to sureties willing to write bonds for these contractors.

As the Program has evolved, there are two plans under which sureties can participate in the Program:

The Prior Approval Program ("Plan A") was the original SBA bond guaranty program. In this program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The surety is permitted to charge the rate for the bond that is on file and approved by the state insurance regulator in the state in which the bond is written. The SBA indemnification of the surety in the event of a claim on the bond in Plan A is 80%, and 90% for bonds written for socially- and economically-disadvantaged contractors and bonds written for contracts under $100,000.

Because of the administrative burden of prior approval, over the years many of the larger, more traditional sureties declined to participate in the Program. Additionally, it appeared over the years that contractors were not graduating out of the Program, but continuing to obtain bonds only with the SBA guarantee. Although there were a significant number of sureties participating, the SBA wanted more of the traditional sureties to participate in the Program. Therefore, the SBA and the industry met to create a program that would be of interest to more sureties. That program is the Preferred Surety Bond Program ("Plan B"). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices, financial strength, etc. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, reimbursement of losses is provided without prior approval of the bond.

For Plan B, since it was enacted as a trial program, the SBA limited the rates that the surety could charge to those that the SFAA (then SAA) filed. At that time, the SAA was the rating organization for the surety industry. In exchange for the reduction in the administrative burden in Plan B, the surety industry agreed to accept only a 70% indemnification instead of the 80% and 90% provided in Plan A. Since that time, the original regulation has become unworkable. SAA stopped filing end rates in 1993, but the SBA never has amended the regulation regarding what the surety should charge for a bond written in Plan B. Unfortunately, this means that current SBA regulations required sureties to charge the end rates that SAA filed in 1987. Only recently has the SBA amended its regulations and eliminated that requirement to use outdated rates. We are pleased that since Plan B is no longer is a trial program, the SBA is moving to administer it accordingly.

The Value of the Program.
In the past ten years, over $8 billion in bonds have been issued to small and emerging contractors through the Program. The Program has provided bonding assistance to small and emerging contractors who might not otherwise be able to obtain bonds. This has been especially true in times of economic downturn when bonding sometimes becomes more scarce and difficult to obtain.

The SBA currently is permitted to guarantee bonds of up to $2 million. This legislation would

increase the cap to $ 3 million, and other legislation pending in Congress would increase the cap to $10 million for public construction projects needed after a natural catastrophe. These recent legislative developments recognize the value of surety bonds on federal construction projects. They also show the desire of Congress that the SBA Bond Program be effective in helping small and emerging contractors, especially now in the Gulf Coast reconstruction.

The Current State of the SBA Bond Guarantee Program.
Over the years, surety participation in the SBA Bond Guarantee Program has ebbed and flowed. On recent factor of change in participation in the Program, however, is the administration of the Program. In recent years participation in the Program has only decreased, and the reasons for this are listed below in the remedies suggested for the SBA reauthorization legislation. The fact is that the SBA Program currently is operating at about one-third of its capacity. While this made a great deal of sense in the years when surety was profitable and companies were writing bonds for small and emerging contractors without any need for the Program, it does not make sense now. The economy is such that there is a significant need for the Program. Some internal problems with the Program have discouraged many companies from participating and caused many that do still participate to limit their participation. The Program no longer makes financial sense to many sureties.

In 2005, the SBA finalized changes to its regulations that would implement an increase in the guarantee fee to surety companies from 20% to 32% of the premium on bonds issued and guaranteed under the Program as of April 3, 2006. This fee increase, which amounts to a 60% hike, will likely make the program economically unattractive for most sureties and will affect the continued viability of the program. Sureties already write bonds with very little margin. This reduction in the premium the surety will receive is untenable.

The fee increase apparently resulted from an Office of Management and Budget (OMB) actuarial study of the SBA's losses under the Program, which led to the conclusion that the SBA had to increase the fees charged to sureties in order to cover its losses. Because of the potential impact on surety participation in the Program, the SBA reconsidered its fee increase and promulgated a regulation changing the percentage of the premium charged to sureties from 20% to 26%, instead of 32%, and also increased the fees charged to the small businesses obtaining a bond through the Program. The overall affect of this proposed revision is to increase the SBA's revenues to cover its losses from the Program, by dividing the burden of the increased costs between the sureties and the contractors.

While we appreciate the proposal to reduce the increase, any fee increase on sureties hurts the small and emerging contractors that the SBA is supposed to assist to the extent that it causes sureties to rethink their participation in the program. Without participating sureties, the SBA will not be there to help small and local businesses.

What is Needed in the SBA Reauthorization Legislation.
The SBA Surety Program remains vital to the growth of small and emerging contractors in America. One, well-run Surety Bond Guarantee Program assures consistency of participation requirements and administrative procedures. Without the SBA Bond Program, many federal agencies may initiate their own program to assist small and emerging contractors. Some already

have done so. States also have begun this process. Duplicative efforts among federal and state agencies waste time and resources that should instead be used to help small businesses.

One of the critical changes needed in the Program has been accomplished -- namely, that the Program staff, including both new and long time staff, is committed to making the Program work well. We also recognize and support the internal efforts of the SBA staff to automate and streamline the application process. This will modernize and improve the Program.

Efforts in Congress need to be aimed at assuring that small and emerging contractors are qualifying for bonds and graduating from the Program because of high levels of participation from bond producers and sureties in the Program. The SBA Reauthorization Act must be aimed at increasing the volume of bonds that the SBA Program writes and increasing the number of sureties participating in the Program. This can be accomplished by the following:

• ***Recognition that the SBA Program Serves an Important Public Policy Function and That It May Not be Self-Sufficient Each Year.*** Congress has never required the SBA Bond Guarantee Program to be self-sufficient. The Congressional declaration of policy for all the SBA programs in the Small Business Investment Act of 1958 was to stimulate and improve the economy by establishing assistance programs for small business which are to be "carried out in such a manner as to insure maximum participation of private financing sources." (15 USC Section 661). If the purpose of the Program is to help small and emerging contractors that may not otherwise qualify for bonds in the marketplace, it stands to reason that there will be losses; and the Program, as originally drafted, acknowledged that fact by recognizing that it could not be self-sufficient. The OMB's directions in the recent past to increase fees to cover SBA losses is a major shift in philosophy and direction for the SBA Program and is in conflict with the spirit of the law. The public policy of helping small and emerging contractors is a sound one, and it needs to be supported in the funding structure and reauthorization of the SBA.

The House legislation would require the SBA to conduct a study of the funding structure of the surety bond program. We think that, when the study is completed, it will show that the Program ebbs and flows with the surety industry and the economy in general. In some years, the Program might break even, while in others years it will not. In all years, however, the Program is vital in assisting small and emerging contractors in obtaining bonding even in years when it cannot break even.

• ***Transparency in the SBA Fee Structure.*** The basis for the fees charged to sureties participating in the SBA Program should be open and apparent. In the last fee increase, the OMB apparently prepared an actuarial study that led to the fee increase. If this was the case, this study should have been made public so that actuaries in the surety industry can review and analyze the data and the conclusions drawn from it. Only then can a meaningful discussion of SBA fees take place. If, for example, more sureties participate and the bond premium volume rises significantly, the current 20% fee will generate more revenue and a fee increase may not be needed.

The House bill permits the SBA Administrator to use funds appropriated to the SBA to reduce fees when funds are available for such purpose. That approach is similar to what has been done

for some of the SBA's loan programs and makes sense to us.

• ***Prevention of the Unraveling SBA Bond Guarantees.*** A strong deterrent to participation in the SBA Program has been the denial of reimbursement to the surety after a claim has been made on a bond issued through the Program. In the reauthorization legislation, we would suggest an amendment to the effect that, once the SBA has approved a bond in the Prior Approval Plan, it cannot reject the bond after it has been issued, provided that the surety made a reasonable attempt to comply with the law.

The House legislation contains a provision that would prevent the unwinding of bond guarantees for sureties participating in Plan A, which requires SBA prior approval for any application for a bond guarantee. We urge that this provision also be extended to Plan B sureties. While the SBA does not approve each application for a bond guarantee application from a Plan B Preferred Surety, it does review and approve the surety's underwriting and claims practices upfront in permitting the surety to participate in Plan B. There is no reason that the SBA should unravel the bond guarantees of Plan B sureties that it has reviewed and approved. If the SBA has problems with the bond guarantees generated from a surety in Plan B, the SBA has the authority to terminate the right of such surety to participate in the Program.

• ***ADR to Resolve Disputes With Sureties.*** If the SBA is limited in its ability to unravel a bond guarantee, the number of disputes with the SBA will be reduced. The SBA should, however, have an internal agency, non-binding alternative dispute resolution (ADR) process to resolve claims issues. Currently, litigation is the only alternative.

We urge the House Small Business Committee to assist sureties in quickly and efficiently resolving disputes with the SBA. The only alternatives now are litigation or walking away from the Program. We think that a mediation program would have not only the benefit of resolving disputes, but also would give sureties considering participating in the Program the knowledge that there is some mechanism in place to resolve disputes, encouraging more participation.

• ***Increased Regional Staffing for SBA Bond Program.*** Several SFAA members have noted the decrease in the number of SBA regional offices and the overall decrease in staffing in Washington, DC, and in the regions. We also find that the staff is inexperienced in the surety business such that we would suggest an appropriation for surety bond education and training.

We understand that the SBA is taking steps to improve its staffing. It has consolidated the regional offices for the Program and reorganized the operations so that they all now report to the main office in Washington, DC. The SBA has openings in the two remaining regional offices, and we have been told that the SBA is committed to filling these with persons with surety underwriting experience.

• ***Elimination of 1987 Rate Requirements.*** The requirements in the federal regulations imposing price controls on sureties in Plan B of the SBA Program became outdated. When the SBA recently revised the regulation and eliminated the requirement of 1987 rates, sureties in Plan B were using 20-year old rates. It still is helpful to include in the legislation a prohibition on price controls so that the regulations cannot again be changed to implement price controls.

Recently, the SBA revised its regulations and eliminated the requirement to use 1987 rates. We think that this shows that the SBA Program staff have listened to sureties as their partner in the Program and are willing to make changes to encourage greater surety participation in the Program. It would be even better if the House legislation contained a prohibition on the SBA getting involved in setting surety rates so that price controls cannot be reinstituted in the future. The 1987 rates were a large obstacle to surety participation in the Program.

What are the Benchmarks for a Successful SBA Program?
We have suggested what the surety industry believes needs to be done in the SBA Reauthorization Act to revitalize the SBA Program so that it is attractive to sureties and agents and assists small and emerging contractors in getting their first bonds and graduating from the Program into the traditional surety market. We think that a common understanding between the surety industry, the SBA and Congress about what constitutes the success of the Program.

According to SBA data, it would appear that participation in the Program is declining. In 1997, the Program guaranteed 16,336 bonds; in 2005, it guaranteed 5,796 bonds and in 2006 it is projected to guarantee 5,000 bonds. In 1992, the Program guaranteed 32,000 bonds. Currently, 10 sureties write through the Program. Four companies account for 89% of the bonds, and one company accounts for 45%.

There are many reasons for the decrease in bonds guaranteed through the Program. One primary driver is the economy, which includes the profitability of the surety industry and the appetite for bonding small and emerging contractors. There also have been some changes in the surety marketplace that may have impacted the bonds guaranteed through the Program and that need to be considered in the operations of the Program going forward. The decrease in bonds in the Program may reflect small businesses growing in size and bonding capacity and "graduating" out of the Program. In addition, some sureties have developed alternates to the Program, such as requiring collateral or funds control and underwriting programs based in part on credit scores, in order to write small and emerging contractors. Other sureties have decided to focus on the small business niche such that more sureties may be writing this business outside the Program. One participant in the Program repositioned its book of business and is now writing larger contractors, and that may account for some of the decline in bonds guaranteed through the Program. The amount of bonds written through the SBA always has varied with the underwriting cycle in the industry. For many sureties, the Program has become an expensive, if not a commercially unreasonable, reinsurer, now that the Program charges 26% of the premium as fees from the sureties. These are all factors that contributed to the decrease of bonds written though the Program in recent years.

Because of these changes in the market, it may well be that the Program will never return to the number of bond guarantees in the late 1990s. That does not mean that the Program is not or could not be successful. It shows that the success of the Program cannot be measured merely by the number of bond guarantees. Rather, the success of the Program needs to be measured by the number of small and emerging contractors that were assisted, and more important, that graduated from the Program to find bonding in the traditional bond market.

Summary and Conclusion.
The continued viability of the SBA Bond Guarantee Program is at stake at a time when the Program is needed the most. Unprecedented rebuilding needs to take place after the devastation of Hurricanes Katrina and Rita in the Gulf Coast region. Small, local and emerging contractors should have the opportunity to participate in this reconstruction. Bonding will be needed on construction projects in the Gulf Coast states for many years to come. The Program will be a vital part in ensuring that small, local and emerging contractors can obtain the bonds to participate in the reconstruction and go about the business of rebuilding their own companies as well.

To make the Program successful, the House Small Business Committee needs to focus on improvements that are needed. The SBA needs to work immediately to encourage more sureties to participate in the bond program so that it is ready for the upcoming spike in applicants for assistance.

The SBA needs to increase numbers of SBA bond personnel in field offices, provide greater surety education of SBA personnel and develop a more streamlined application process.

CNA Surety and the surety industry in general are willing to provide any assistance in making these changes. We support the continuation and revitalization of the SBA Bond Program. We believe that the SBA and sureties must be business partners in making this Program work. SFAA and AIA both are located in Washington DC and can be called upon to answer questions about surety from Members of Congress and their staffs, and to address issues related to the SBA Program.

The current leaders of the Program appear committed to the Program, and have been working hard to revitalize it. However, they cannot do it alone. Congress must be a part of this solution.

Thank you.

House of Representatives Committee on Small Business
September 6, 2007
"A Hearing to Consider Legislation Updating and Improving the SBA's Investment and Surety Bond programs"

Testimony of:
Robert J. More, Partner
Domain Associates
San Diego, California
Final

Introduction

Chairwoman Velazquez, Ranking Member Chabot, and members of the Committee, my name is Bob More and I am a partner at Domain Associates, a venture capital firm with offices in Princeton, New Jersey and San Diego, California. I am also a member of the National Venture Capital Association based in Arlington, Virginia. My views today represent 460 member firms which currently comprise approximately 90 percent of all the venture capital under management in the United States.

Domain Associates invests exclusively in young life science focused businesses with outstanding growth potential. Our three major investment segments are pharmaceuticals, specialty pharmaceuticals, and medical devices, while additional areas of interest include biomaterials, bioinstrumentation, and diagnostics. The partners of Domain have been involved in the formation and growth of more than 190 life-sciences companies. We typically prefer to be a part of the first institutional financing round of the company and look for companies with outstanding technology addressing unmet needs in very large markets. Once invested, in the vast majority of cases, Domain will take a seat on the Board of Directors and work closely with other members of the Board and management to guide the growth of the business.

I would like to thank the Committee for the opportunity to share with you today the challenges that our small venture backed businesses have faced recently as it relates to current SBA policies and why we believe the Small Business Investment Expansion Act of 2007 is a positive step towards mitigating these challenges and fostering the type of

private/public partnership that will allow the United States to sustain its economic leadership for years to come. To date much of the Congressional debate around SBA's policies and interpretations have focused on the details and nuances of each particular issue. On behalf of the venture capital community, we think it is important to take a step back and for you, the Congress, to ask what can be done to best support the creation and development of small businesses in the United States. We believe partnerships between government and the venture capital community have and will continue to be one of these winning strategies.

Venture Capital Investment Overview

I would like to briefly explain how the venture capital industry creates and grows small businesses. Typically venture firms raise their funds of money from institutional investors such as pension funds, endowments and foundations with the charter to invest those funds in promising young start up companies. Once a fund is raised, we look for the best and brightest entrepreneurs in which to invest, usually within a specific industry sector in which we have an expertise. Venture capitalists most often look for companies that are innovating in a significant way. For this reason, we are often associated with high technology or life sciences businesses. We often find these entrepreneurs in university and government labs, through others who are already in our network, or we work with entrepreneurs who we have successfully funded in the past.

In order to be considered for venture capital investment, the entrepreneur typically has a product or service that has gone through the discovery process and is ready to be clinically tested and commercialized. We stay invested in these companies – both financially and through the sweat equity we offer – for anywhere from 7-10 years, often longer and rarely less. The ultimate goal is to build the business until it can go public or become acquired, generating a return for our institutional investors. In 2006, the venture capital industry invested $26.3 billion into more than 3500 deals in the United States.

Venture Backed Companies Drive US Economic Growth

Venture capital investment has remained at a consistent level during the last five years during which time the United States economy has been facing new challenges. Since early 2000, we have faced the off-shoring of highly skilled jobs and the consolidation of older industries, all at a time when developing nations such as China and India are building up their infrastructures and ecosystems to become more formidable competitors. We all agree that to continue our global leadership, the United States must foster an ongoing environment where new companies continue to grow, innovate, and create jobs here.

The federal government has called on the private sector to help meet this challenge. The venture capital community has responded and backed thousands of small businesses which have played a critical role in developing new industry sectors, creating highly skilled US jobs, generating more revenues, and bringing innovative products and services to the US market. According to the econometrics firm Global Insight, in 2006, venture backed companies accounted for 10.1 million jobs and $2.3 trillion in US revenues, equating to 9 percent of US private sector employment and 18 percent of US GDP. Companies that were once small venture backed businesses include: Google, Genentech, Intel, Cisco, Starbucks, Microsoft and Federal Express. Today, I am here on behalf of the next Google or Genentech that is currently being funded by a venture capital firm and because of this, is significantly disadvantaged by current SBA policies.

Current SBA Policies Hurt Venture Backed Companies and the Economy

Since 2001, a change in the interpretation of policy at the Small Business Administration (SBA) has run in direct opposition to the premise that venture backed businesses are one of the most promising vehicles driving US economic leadership and should be supported wherever possible. Specifically, we are troubled by the SBA's recent interpretation of its affiliation rule in determining whether a business entity meets the small business criteria of having less than 500 employees. Under the existing affiliation requirements, a business concern can have no more than 500 employees, including its affiliates to qualify as a small business. Under this requirement as it was historically applied, most venture backed businesses would meet the

criteria. Our companies are very small, especially in their early years. However, SBA has recently applied a formula which sweeps in the venture capital firm AND the employees from every company in which the venture capital invests when considering a venture backed company for small business classification. They have applied this formula even though the company in question has absolutely no relationship to the other companies and their employees. Unfortunately, I have been involved in one of these instances over the past year.

Case Study

Approximately nine months ago, one of my firm's small, developmental stage portfolio companies, which is working to develop a new specialty pharma product, filed a new drug application (NDA) with the Food and Drug Administration, requesting a small business waiver for the FDA's fee for reviewing the application. The fee was approximately $900,000. The FDA's fee waiver program is intended to benefit small businesses, exactly like our portfolio company. Section 740(d)(1)(A) of the FD&C Act provides that the FDA shall grant a waiver for or a reduction of one or more of the fees where the FDA finds that: *"the assessment of the fee would present a significant barrier to innovation because of limited resources available to such person or other circumstances."*

In order to qualify for a fee waiver, a company must have fewer than 500 employees, including employees of all affiliates. An "affiliate" is defined as a business entity that controls or has the power to control another entity.

The FDA requested that the SBA conduct a formal size determination with respect to the Company's eligibility for the waiver of the fee. In February, the Company filed the appropriate paperwork with the SBA. The paperwork showed that the Company has <u>never</u> had any revenues and, that during the three-year period prior to the filing of the NDA, the Company averaged 7.25 employees. Given that this level was well below the 500 employee threshold, the Company assumed that it would be eligible for the waiver.

Little did the Company know that we were about to begin quite an adventure with the SBA. A month after the appropriate forms were filed, the SBA notified the Company that it had determined that Domain controls the Company. They requested information with respect to Domain's ownership interest in all of its other unrelated portfolio companies, so that the SBA could determine if Domain also controlled those companies. If Domain was deemed to control any of the other companies, they would be deemed to be "affiliates" of the Company. The SBA also requested information with respect to the number of employees at Domain's other portfolio companies.

The SBA concluded that Domain controls the Company because it has a 34 percent ownership interest in the Company and it is the single largest shareholder. The Company and its counsel explained to the SBA that Domain only has the right to elect one out of six Directors and that neither Domain nor any of the three other venture capital firms invested have the ability to unilaterally exercise either affirmative or negative control over the Company. The Company and its counsel further explained that Domain may be the single largest shareholder, but as a practical matter, Domain does not control or have the ability to control the Company.

In response to this explanation, the size specialist at the SBA responded by saying, "that may be true, but the SBA does not deal in the real world." The size specialist continued to insist that Domain provide information with respect to its other portfolio companies and Domain's Controller spent countless hours obtaining and providing such information. It should be noted that Domain's other portfolio companies also spent a significant amount of time providing the information relating to the ownership of such companies and the number of individuals employed by each.

At this point, the time it was taking for the determination, and the uncertainty of the situation, was becoming significantly problematic from a market standpoint. In order not to jeopardize its NDA, the Company paid the $900,000 filing fee to the FDA and has now requested a refund, if the SBA ultimately finds that it qualifies for classification as a small business. This is a sum of money that would otherwise be directed towards the Company's growth through additional research, hiring of key management, or market development.

The Company and its counsel have provided the SBA with information and facts that clearly establish that Domain is not an affiliate of and does not control or have the ability to control the Company. The Company, which presently has eight employees, clearly qualifies for classification as a small business. Earlier this week, the Company was advised by the SBA that, after more than seven months since the FDA requested that the SBA conduct the size determination, the SBA is still working on the matter. This process has clearly harmed the kind of small business that the SBA was established to help. My understanding is that we are not alone in this predicament and that the SBA is using this flawed reasoning with other venture backed companies. It is clear "the SBA does ***not*** deal in the real world" and, by its actions, is presenting a significant barrier to innovation.

On the technical merits it is difficult to understand how the SBA justifies their position when it directly contradicts language in the Small Business Investment Act which seems to address this very issue. Section 103 of the SBIA states that an investment by a venture capital firm:

(A) shall not cause a business concern to be deemed not independently owned and operated regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment;

(B) shall be disregarded in determining whether a business concern satisfies size standards established pursuant to section 3(a)(2) of the small business act

From this language it seems clear that ownership by a venture capital firm would not trigger the Affiliation Rule for programs that were created under the SBIA. Furthermore interpretation by the SBA to the contrary runs in direct opposition to the intent by Congress to encourage venture capital funding of small businesses.

SBA's Misperceptions

It appears that the SBA has the gross misperception that small businesses that receive venture backing should not be considered a "small business" and do not need to compete for small business grants, contracts or even get small business waivers. If they have already received venture capital funding, why do they need government dollars? The answer lies in the investment model that venture capitalists have used for decades. Our industry is focused on building companies that will commercialize their product or service. We typically enter an investment when the early stage research has been completed and a hypothesis has been proven. Therefore, a small business must leverage other sources of financing to bring research to the stage where it can be commercialized by a venture capitalist. Often a venture capitalist is funding one product while the company is building a pipeline of new products through basic research. The new products often require non-VC funding sources such as the SBA or an SBIR grant. Without this funding, many innovative technologies would linger "on the shelf" because they would not reach the stage where they could be brought to a venture capitalist and subsequently commercialized.

Intuitively, it would seem that the SBA would want to fund venture backed companies because these companies have already been vetted by professionals who think highly enough of the management team to invest. Unfortunately, this is not the case. The current interpretation by SBA could be likened to a situation in which the NIH would refrain from funding any project at a well endowed academic institution because they already have money behind them. Clearly, this is not the case with the NIH because the reasoning behind such a premise is fatally flawed. So too is the SBA interpretation of venture backed companies. These companies have just as great a need as non-venture backed entities – and are probably better positioned to succeed. So

while Congress and the Administration are doing all that they can to promote job growth and innovation, the SBA policies have ironically been stifling it.

This issue of the SBA discriminating against venture backed companies is not limited to the affiliation rule. We are facing similar issues when applying for Small Business Innovative Research (SBIR) grants. Here the SBA has used VC ownership as a reason not to grant basic research funds to our companies that have very promising projects waiting for funding. Though not the focus of today's discussion, it is worthy of mentioning because it demonstrates a pattern of animosity of the SBA towards venture backed companies and it too needs to be fixed.

Support for Legislation

NVCA supports the Chairwoman's efforts in crafting the Small Business Investment Expansion Act that will provide incentives for venture capital firms to invest in small businesses nationwide and promote entrepreneurship which is critical to creating jobs and discovering new innovations in this country. We specifically support Title V of the legislation which will resolve the SBA's affiliation issue and which will clarify SBA's affiliation rules by ensuring that businesses with venture capital investment are not penalized for a venture capital firm's additional investment in other portfolio companies that have no relationship to one another.

Title V of the legislation will amend Section 3(a) (1) of the Small Business Act clarifying that for the purposes of determining whether a small business concern is less than 500 employees and is independently owned and operated, the SBA shall not consider a small business concern that has received investment by a venture capital operating company to be affiliated with either the venture capital operating company or any other business in which the venture capital operating company invests. It will also put in place proper safeguards to ensure that this provision cannot be exploited by large businesses by specifically defining a venture capital operating company.

Conclusion

Current and past Administrations have recognized the important contribution of venture capital investment in fostering innovation but SBA's policies continue to contradict these incentives. Over the years, current and past Administrations have focused on marshalling the economic resources to help spur innovation and develop programs that would provide incentives to foster public-private private partnerships to further the country's economic goals. The American Competitiveness Initiatives, the Department of Defense-Defense Venture Catalyst Initiative, In-Q-Tel and DARPA (Defense Advanced Research Projects Agency) are a few examples of these types of programs. But the SBA's policies have and will continue to have a chilling affect on the federal government's ability to leverage the most promising small businesses in the country.

No other asset class supports the premise more that small businesses are the life blood of the US economy than venture capital. As investors in these important entities, we are advocates for their viability and growth. We are not sure what world the SBA operates in, but in our world all of these small businesses should all have access to the same benefits, because they are all promising entities that are promoting job growth and innovation. The actions of the SBA are doing nothing but stifling this process which has been so beneficial to the US economy for so long. We are confident that the proposed legislation is a positive step in keeping us all in the real world and assuring that the United States maintains its competitive edge by supporting small businesses of all kinds.

Thank you.

HEARING TESTIMONY
SCOTT KOENIG, M.D., PH.D.
PRESIDENT AND CHIEF EXECUTIVE OFFICER
MACROGENICS

ON BEHALF OF
THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

BEFORE THE HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS

"A HEARING TO CONSIDER LEGISLATION UPDATING AND IMPROVING THE SBA'S INVESTMENT AND SURETY BOND PROGRAMS"

SEPTEMBER 6, 2007

Chairwoman Velazquez, Ranking Member Chabot, and Members of the Committee:

I appreciate the opportunity to testify before the Committee today regarding the Small Business Investment Expansion Act and the critical role venture capital investments plays in small biotechnology companies.

My name is Dr. Scott Koenig and I have been President and Chief Executive Officer at MacroGenics Inc. in Rockville, Maryland since 2001. Prior to joining MacroGenics, I was Senior Vice President of Research at MedImmune Inc., where I participated in the selection and maturation of the company's pipeline. From 1984 to 1990, I worked at the National Institute of Allergy and Infectious Diseases where I investigated the immune response to retroviruses and the pathogenesis of AIDS. I am a member of the Board of Scientific Counselors at the National Institute of Allergy and Infectious Diseases at the National Institutes of Health and was elected as a member of the Emerging Companies Section Governing Body of the Biotechnology Industry Organization (BIO). I am also Chairman of the Board of Directors at Applied Genetic Therapy Corporation, a private venture-backed biotechnology company in Alachua, FL developing genetic therapies using adeno-associated virus vectors.

MacroGenics is a private venture-backed biotech company whose mission is to develop immune-based products including monoclonal antibodies to treat patients with cancer, autoimmune disorders, allergy, or infectious diseases and vaccines. MacroGenics was founded in 2000 and has 87 of employees. We do not yet have an FDA-approved therapy

on the market. We just started Phase 3 clinical testing, that is broader scale safety and efficacy testing, of a monoclonal antibody to treat patients with new-onset juvenile diabetes and Phase 1 safety testing in normal volunteers of another therapy to treat patients with West Nile virus. A Phase 1 clinical study with a monoclonal antibody candidate to treat another autoimmune disease, ITP, is ongoing with our partner Genzyme.

Today, I am testifying on behalf of BIO, an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The overwhelming majority of BIO member companies are small, early stage research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy.

Biotechnology Companies' Aggressive Capital Needs

The largest obstacle to delivering on the scientific promise of biotechnology is accessing sufficient capital to fund research and development. BIO has over 600 emerging companies in its membership. These firms have fewer than 350 employees and do not yet have a product on the market.

Promising biotechnology research has a long, arduous road from preclinical research, through Phase I, safety, Phase II, efficacy, and Phase III, broader population clinical trials, and ultimately to FDA approval of a therapy. It is estimated that it takes between 8 and 12 years to bring a biotechnology therapy to market and costs between $800 million and $1.2 billion[1]. In the absence of product revenue biotechnology companies are almost entirely reliant on the capital markets or other sources of financing to fund research and development. This is particularly challenging at the earliest, highest-risk stages of research and development. The majority of biotechnology companies are therefore without any product revenue for a decade or more. As a result, the significant capital requirements to advance a new therapy to the market necessitate fundraising through a combination of angel investors, venture capital firms and occasionally other investors.

Let me be clear that the role and importance of venture capital fundraising in the biotechnology industry cannot be understated. In 2006 alone, venture capital investment in the life sciences and medical devices industry totaled $7.2 billion in 2006, up from $2.8 billion in 1998.

Typically, a biotechnology company will begin by fundraising for its lead product in development. Companies generally raise between $5 million and $15 million in their first round of venture financing, an amount that usually results in multiple venture capital companies owning more than 50 percent of the company. This is especially the case with very young companies whose evaluation may reflect their high-risk, early stage nature.

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[1] Tufts Center for the Study of Drug Development.
http://csdd.tufts.edu/NewsEvents/NewsArticle.asp?newsid=69

However, it is often the case that no single venture capital company will own more than 15 to 20 percent of the equity. In the case of MacroGenics our lead product is a monoclonal antibody to treat patients with new-onset juvenile diabetes, which as I previously stated, is beginning Phase 3 clinical trials. To get to this point we undertook three rounds of private fundraising involving over a dozen venture capital companies.

Emerging biotechnology companies are generally a collection of research projects that range from very-early to early stage development. In addition to the lead therapy in development, biotechnology companies have on average 5 other therapies or candidates in development, which are often times at the very earliest stage of development, pre-clinical research.[2] These candidates may be an outgrowth of research on the lead product or a result of utilizing a particular technology to address a different disease with a completely different set of intellectual property.

Despite the extensive fundraising that a biotechnology company undertakes for the lead product, these funds are generally not interchangeable. That is they are often tied to very specific milestones to support the lead product's development. In order to develop secondary or tertiary candidates/therapies, a company normally has to find secondary sources of fundraising capital. At the very earliest stages of development this is particularly challenging, and it is often times in this capacity that other sources of financing, like Small Business Investment Research (SBIR) grants, have been instrumental in advancing research and development in biotechnology.

The Impact of Imperfections in the Private Capital Market

Venture capital financing plays a critical role in the development of small biotechnology companies. Especially since emerging biotechnology companies do not yet have an FDA-approved product on the market and therefore lack any significant revenue source. In a BIO-sponsored survey of its emerging companies, the largest portion of companies, 40 percent had less than $150,000 in annual revenue last year[3].

However, the market is not perfect and not all worthy projects receive limited venture funding. Unfortunately, small businesses do not have the internal resources to overcome or wait out those market imperfections. However, this is key, because if private capital market is the *only* financing option available to small biotech companies, then good science will inevitably be delayed, impacting most importantly patients, but also economic development in this high technology sector of the economy.

This is not a criticism of the venture capital community. The venture capital community is very astute and adept at evaluating the scientific merit and market potential of biotechnology companies' research, as well as the strength of a company's intellectual property and management. The United States is the world leader in biotechnology, and

[2] BIO sponsored, third-party administered, survey of 144 BIO emerging companies' Chief Executive Officers and Chief Financial Officers, March-April, 2007

[3] BIO sponsored, third-party administered, survey of 400 BIO emerging companies' Chief Executive Officers, Chief Financial Officers, and Executive Vice Presidents November, 2006

this in large part can be attributed to our robust capital markets. However, the venture capital community has limited funds; furthermore, there is also science that is too-high risk or too-early stage to entice venture capital investment.

This particular failure in the private capital markets is well recognized and often referred to as the "valley of death" because it is the point at which good science can wither for lack of funding. *Nature Biotechnology* described the dynamic by stating that, "The technology transfer gap has always been with us, but in drug discovery it has widened to form a valley of death between the traditional finishing point of research supported by an academic grant, and the sort of programs industry is interested in licensing or venture capitalists are prepared to back through a start-up."[4] It is at this point that important opportunities can be delayed, sometimes permanently, at small biotechnology companies.

At this juncture, a larger company will generally have access to existing revenue or traditional loans through banks to overcome this funding shortfall. However, this is rarely an option for small biotechnology companies. Because of the very long development time for biologic products, small biotechnology companies may be unable to repay a loan for a decade or are forced to use the loan proceeds to pay the interest, which is something most banks are unwilling to do. Instead, small biotechnology companies must access creative, non-traditional financing sources if the companies are to bridge the "valley of death".

The good news is that it does not take an extraordinary amount of funding to bridge the funding gap. Funding options available to small biotechnology companies include angel investors, historically SBIR grants, and a very small, selective set of venture capital philanthropists. A venture capital philanthropist is a term that describes non-for-profit foundations that invest in biotechnology therapy research and development at companies with the primary goal of delivering new treatments to the patients that the foundations serve. For example, MacroGenics has entered into a $2 million partnership with the Juvenile Diabetes Research Foundation (JDRF), the world's leading charitable funder of type 1 diabetes research, to support a pivotal multinational Phase II/III clinical trial of teplizumab (MGA031), a proprietary compound that has shown promise in slowing the progression of type 1 diabetes in children and adults newly diagnosed with the disease.

Despite the options available, gaps continue to persist that hold real consequences for patients and the small biotechnology companies. This situation is further exacerbated by the Small Business Administration's use of outdated rules and regulations to define small businesses that in large part exclude the majority of small biotechnology companies from accessing grants or programs. For example, Applied Genetic Therapy Corporation was planning on developing a therapy for a fatal orphan disease in children called Pompe's disease. Applied Genetic Therapy Corporation has 23 employees, no marketed products, and has undergone just one round of venture capital fundraising. However, according to the SBA they are not in fact a small business because of their venture capital investment, which is a necessity for the company. As a result of this determination, despite garnering a peer-review score from the NIH high enough to receive an SBIR grant, the company was unable to accept the funding. Since that time, no further research has been done on this

[4] Nuala Moran, "Public Sector Seeks to Bridge 'Valley of Death'", *Nature Biotechnology*, 25 (2007): 266.

project and the research was not sufficiently advanced to attract additional venture capital support. The SBA's decisions in this area occur in a bureaucratic vacuum. However it has a very real impact on the patients awaiting cures, our employees, and the economy.

Small Business Investment Expansion Act

The Small Business Investment Act aims "to stimulate and supplement the flow of private equity capital and long term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply."[5] Additionally, Congress has made clear that this policy should be carried out so as to maximize the participation of private financing sources. These goals continue to be as important today as they were when the original Act was signed into law in 1958.

BIO supports and applauds the Committee's efforts to recognize the importance of both private capital financing as well as the unique financing challenges facing small businesses and the opportunities for the government to help facilitate growth in this vital sector of the economy. The Small Business Investment Expansion Act continues to address the unique financing challenges of small businesses and will modernize the SBA's rules defining a small business so that small biotechnology firms are not prevented from accessing assistance and grants simply because venture capital is a part of the business model. The Committee's foresight will help ensure that the SBA programs and grants assist both mom and pop shops and small cutting edge technology companies, both of which play a vital roll in a vibrant economy.

The Committee's efforts also impact United States competitiveness. It should be made clear that while the SBA holds onto outdated rules, other countries are moving forward to support their domestic high-technology companies. Nature Biotechnology quotes Roberto Solari, the chief executive of the technology transfer arm of the UK's Medical Research Council, as stating that in response to the widely "valley of death" phenomenon, "every public sector funding body around the world is getting into this area."[6] Congress should not take for granted that the United States will always lead the world in biotechnology and other life sciences. Failure to adapt to the modern economy will affect the ability of the biotechnology sector to thrive.

Congress can continue to support the United States biotechnology community by allowing the government to partner with small biotechnology companies, that have promising science but need resources at key stages of development that are not readily available in the private capital markets.

Again, thank you for providing me with the opportunity to testify today before the Committee.

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[5] Small Business Investment Act of 1958, P.L. 108 447, Sec. 102. Statement of Policy
[6] Moran, 266.

Statement of
Dr. Robert D. Atkinson

President

Information Technology and Innovation Foundation

The Role of Legislation Affecting
the Small Business Administration's Investment Programs

before the
Committee on Small Business
U.S. House of Representatives

September 6, 2007

Madame Chairman, Mr. Chabot, and members of the Committee, I appreciate the opportunity to appear before you today to discuss potential legislative changes affecting the Small Business Administration's (SBA) investment programs, particularly those affecting angel investors. I commend you for addressing this important issue of how the SBA can do an even better job of supporting entrepreneurship and new firm formation, and I strongly support this legislation.

I am president of the Information Technology and Innovation Foundation. ITIF is a non-partisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity internationally, in Washington, and in the states. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on innovation, productivity, and digital economy issues. I have been involved with economic development and entrepreneurship for many years, including as the first Executive Director of the Rhode Island Economic Policy Council, a public-private partnership including as members the Governor, legislative leaders, and corporate and labor leaders. I have also written extensively about these issues, including most recently in the ITIF report, "The 2007 State New Economy Index," which assesses the extent to which the 50 state economies are structured according to the tenets of the New Economy and outlines the next generation of innovative state-level public policies needed to meet the challenges of the New Economy.

The Role of Entrepreneurship in U.S. and State Economic Success: In the new global economy, competitive advantage for the United States, states, and local communities is increasingly based on innovation and the generation of new business models. With low-wage developing nations an increasingly attractive option for U.S. firms, fewer U.S. companies are establishing greenfield plants domestically. Indeed, the number of industrial manufacturing relocations and significant expansions in the United States has fallen from an average of 5,139 per year for 1995-2000 to 3,162 in 2005.[1]

As a result, in order to succeed in the new global economy, the United States, as well as states and sub-state regions, have to look more to innovation and entrepreneurship for economic advantage. Entrepreneurship is particularly important because new and fast growing firms are precisely the kinds of firms that don't become commodity producers searching for any number of interchangeable low-cost locations. This means that entrepreneurial firms tend to be more "sticky," with local entrepreneurs usually growing their firms in the state they live in. For example, more than 80 percent of scientists in California research institutions that went on to start their own firms did so in California.[2] Just how important is entrepreneurship? Although only one in twenty entrepreneurial firms are high growth in terms of adding jobs, firms that survive the first few years create jobs and also often innovative goods, services and processes.[3] In fact, this relatively small number of fast-growing firms account for the lion's share of new jobs created. Between 1993 and 1999, the number of these fast growing "gazelle" companies (companies with annual sales revenue that has grown 20 percent or more for four straight years) grew almost 40 percent, to over 350,000. One study estimates that such "high expectations" entrepreneurs are responsible for 80 percent of the jobs created by entrepreneurs.[4]

While entrepreneurship is an important source of economic opportunity in the U.S., the role of such gazelle entrepreneurs differs significantly by state. While in 2006, about 8 percent of U.S. jobs were in these fast-growing companies, in Nebraska, the leading state in the nation, over 16.6 percent of jobs were in gazelle companies. The next four leading states were Delaware (13.5%); New York (11.7%); Maryland (11.6%) and Arkansas (11.3%).[5] What is perhaps most striking about these data is that this kind of entrepreneurial energy is not just confined to the wealthiest and most high-tech states.

The Role of Government in Supporting Entrepreneurship and Entrepreneurial Financing: At its core entrepreneurship is driven by individuals willing to take risks and able to execute their plans. Government can never be a substitute for that, nor should it try. But what government can and should do is make entrepreneurship and new business formation easier for individuals. One key way to do that is to help enable capital formation, which is a core part of the mission of the Small Business Administration. Indeed, studies show that access to capital is a key factor in small business success.

However, some might argue that the federal government should have little or no role with regard to venture, seed, and angel investing. To be sure, the United States has vibrant capital markets and the world's best venture capital sector. To be sure, the lion's share of funds for new ventures come from and should come from the private sector. It's the private sector that can best assess risk and opportunity.

However, notwithstanding these strengths, it does not mean that there are not gaps in the market and that there is not a supportive role government can play. There are a number of reasons why governments can play a supportive role, particularly in the area of early stage and angel investing. One reason is that over the last decade the venture capital market has increasingly shifted toward later-stage, larger deals. Even though the United States has the most well developed venture capital markets, significantly less is invested

in zero and first stage venture deals than a decade ago. While venture capital has increased nationwide since 1996 by almost double, the amount invested in zero and first stage investments has fallen by half.[6] There are perfectly good reasons for why this has happened – primarily that VC firms can make as much money investing in one large deal as in two smaller deals, but with less time and expense. But while it's rational for venture and other investment firms to do this, it does mean that there is a gap in the market that makes it hard for firms requiring less capital that might in fact be viable, high-growth firms to get financing.

Second, venture capital is highly concentrated in a few states. In fact, since the height of the VC boom in 2000, venture capital has become even more geographically concentrated. In 2005, 79 percent of investments went to the top 10 states, up from 69 percent in 2000. For example, as a share of their economies, Massachusetts and California receive almost 4 times more venture capital than the national average. This matters because in spite of what we all read in our college economics textbooks about rational investors, venture capitalists are human beings who tend to make their investments close to home. The same holds true for angel investing; it has been reported that 90 percent of firms receiving such investments are located within a half-day's travel time of their principal investor. This could be a result simply of inertia or perhaps an understanding that the best investments are the ones that can be regularly monitored, and physical proximity enables that. But either way it means that many parts of the country have less access to early stage financing.

One result of this geographic concentration and the focus on bigger, later-stage deals is that state governments are playing important roles in ensuring access to early stage equity capital. In 2006, 44 states had established 155 programs investing more than $5.5 billion.[7] And perhaps the area that is seeing the most rapid growth of state interest is angel capital, the capital invested by (usually) wealthy individuals in a region's businesses. States are playing a key role by helping to link angels and entrepreneurs.[8] For example, the Wisconsin Angel Network (WAN) represents more than 200 individual investors and helps match them with start up and young companies. Similarly Pennsylvania's Ben Franklin Investment Partners (BFIP) guarantees up to 25 percent of any loss experienced by a qualified private investor who makes an investment in a qualifying southeastern Pennsylvania emerging technology enterprise. A number of states also provide a modest tax credit to angel investors for investing in an in-state firm.

Indeed, angel investing is becoming as important as venture capital in supporting entrepreneurship. In 2005, angel investors actually invested more ($23.1 billion) than did venture firms ($22.4 billion).[9] State venture capital programs invested about a tenth of this amount ($2.2 billion).

But states are limited in what they can do. They have more limited budgets than the federal government. Moreover, angel and seed funding investments take time to pay off in terms of economic activity and jobs, and for most states the political pressures lead them to focus on economic development policies that lead to more immediate and highly visible results. Recruiting the big factory is often a more politically appealing strategy than supporting entrepreneurship. Moreover, spill-overs from entrepreneurial activities to other states mean that states have less incentive to invest in entrepreneurship.

For all these reasons, it's important that the federal government through the SBA plays a supporting role in helping ensure access to equity financing.

Specific Comments on the Legislation: Overall this legislation is an important step in helping spur the entrepreneurial economy. While I focus most of my comments on Title III, I will make one comment on Title I that addresses the SBIC program. Since it was revised over a decade ago, the SBIC program has been a very effective tool. However, if all the SBIC program does is provide lower cost capital to venture firms investing in late and large deals, it is not fulfilling its purpose of addressing a market failure or limitation. Therefore, the bill's provisions to target SBIC investments, especially to smaller enterprises, are an important and needed reform. The Committee may want to consider going even further and requiring that some share of funds (perhaps not less than 25 percent) also go to smaller deals (perhaps less than $2 million), not just smaller enterprises.

The establishment in Title III of a new angel investment program is a positive step forward that will help spur the availability of angel capital, not just nationally but in regions and communities that up until now may have had limited access to angel capital. There are however, in my opinion, several changes the Committee may want to consider to strengthen this provision. First, as currently drafted, the program defines an angel group as "two or more angel investors." I believe this number is too low and should be expanded, perhaps to five or ten angel investors. There are two reasons why the Committee might consider this. First, I believe that it would reduce the likelihood of fraud if there was a requirement to have a larger investor group. Second, one of the goals of federal programs like this is not just to provide capital, but to spur the establishment of new kinds of organizations to facilitate entrepreneurship. In other words, one of the keys to this effort is to leverage and encourage angel *networks*, not just angel *investment*. Requiring larger angel groups will help spur more networks and more investors. Moreover, given the relatively modest level of funding in the bill, I do not believe that such a requirement would limit the program's ability to invest all of its resources.

Second, while it is important to require matching investments by angel investors, I believe that the language in Sec. 382 (g) could be clearer. It should state clearly that angel investors do not need to get approval from the SBA for every deal they invest in. This kind of approval requirement would limit the investors' flexibility and need for prompt decision-making. The provision that they must put up at least 50 percent of their own funds in the sum of all the deals involving federal support makes sense. I would suggest, though, that the legislation (or SBA) place some kind of time limit on the angel groups in terms of when they invest the funds. For example, if they have not invested the funds in less than three years, they will not receive the rest of the funds for investment.

Toward the goal of helping establish angel networks, I believe that the grant program for the establishment of angel groups (Sec. 384) is a positive step forward. Often, the biggest market failures are failures of information and coordination. States like Wisconsin that have put modest resources toward establishing angel networks have found that the process of bringing angel investors together and helping entrepreneurs get in front of

them have paid off with more entrepreneurial financing. The proposed grant program can help build on the experience of these programs and extend these models nationwide. My one suggestion that the Committee might consider would be to add in a match requirement (perhaps 50 percent in cash for state or local governments and in-kind for the other organizations). Adding a match requirement would not only ensure that organizations applying for the grants have "skin in the game" but would also help leverage non-federal resources.

Finally, I strongly support the idea to create a Web-accessible angel capital database (sec. 383). However, I would encourage the Committee to include language that makes the data in the database available for anyone else to use in their own databases. If the database is only accessible on the SBA website, I believe that it will have only limited use. However, if SBA is required to make the data available in machine readable form to anyone else that wants it, it would be available on websites of many other organizations that entrepreneurs frequent more often than SBA's site. These might include entrepreneurial magazines (e.g. *Inc. Magazine*), specialized entrepreneurial web sites, (vfinance.com), etc.

Overall, ITIF supports this legislation as a positive step in spurring America's entrepreneurial economy. Thank you for letting me share my views with you and I would be happy to answer any questions you might have.

Notes:

[1] "Year-to-Date New Plant Report," (Conway Data, Inc, 1991-2005).

[2] Junfu Zhang and Nikesh Patel, "The Dynamics of California's Biotechnology Industry," (Public Policy Institute of California, 2005), cited in Joseph Cortright, "The Young and Restless in a Knowledge Economy," CEOs for Cities (Dec. 2005). <www.ceosforcities.org/rethink/research/files/CEOs_YNR_FINAL.pdf>..

[3] Erkko Autio, "High-Expectation Entrepreneurship 2005," *Global Entrepreneurship Monitor* (2005). <http://www.gemconsortium.org/document.asp?id=444>.

[4] Ibid.

[5] Robert D. Atkinson and Daniel K. Correa, "The 2007 State New Economy Index," (Washington, DC: The Information Technology and Innovation Foundation, Feb. 2007). <www.itif.org/index.php?id=30>.

[6] National Science Foundation, "Science and Engineering Indicators 2006," (Washington, DC, 2006). <http://www.nsf.gov/statistics/seind06>.

[7] Susan P. Strommer, George Lipper, and Daniel Sandler, "Seed and Venture Capital: State Experiences and Options," (The National Association of Seed and Venture Funds, May 2006). <www.nasvf.org/web/nasvfinf.nsf/pages/svcp.html/$file/Seed%20and%20Venture%20Capital%20Report%20-%20Final.pdf>.

[8] See National Governors' Association, "State Policies for Supporting Angel Investing," (2007).

[9] Council on Competitiveness, "Competitiveness Index: Where America Stands," (2006).

Statement
of
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Before The

United States House of Representatives
Committee on Small Business

September 6, 2007

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Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee:

Thank you for the opportunity to appear today to give NASBIC's views on the proposed "Small Business Investment Expansion Act of 2007." My remarks will address the sections of the proposed legislation related to the Small Business Investment Company (SBIC) program. However, before turning to those sections, I would like to begin with some background information. First, there are three distinct parts that make up the whole of the SBIC program.

1. **The Debenture program.** The Debenture program has been in operation since the start of the SBIC program in 1958. Since 1994, its purpose has been almost exclusively to promote debt financing (generally subordinated debt) of U.S. small businesses. The program design is very simple and effective: Debenture SBICs borrow money periodically by issuing SBA-guaranteed Debentures (generally 10-year obligations) that bear low interest rates by virtue of SBA's guarantee. The loans augment SBIC private capital (the minimum required is $5.0 million) by a ratio that generally does not exceed 2:1. The private capital and borrowed money is then available to invest in small businesses at higher rates of return—with SBA setting the maximum rates of interest that can be charged. SBICs pay interest on Debenture leverage semiannually, but the principal need not be repaid until the end of the term. There are currently 134 Debenture SBICs managing $6.1 billion in committed capital resources.

2. **The unleveraged, bank-owned SBIC program.** Prior to passage of the Gramm-Leach-Bliley Act (GLB) in 1999, banks were prohibited from owning more than 5% of the equity of a portfolio company unless the ownership was held by a licensed SBIC. Thus, the SBIC program provided the only way banks could operate venture capital or private equity funds for business purposes. This led to the creation of many large bank-owned SBICs (e.g., Chase Capital Partners; Citicorp Ventures) that invested in SBIC program target U.S. small businesses, but did not use government-guaranteed leverage to augment their capital because they could use depositors' capital at less cost. The popularity of the program among banks was such that their investments represented by far the largest percentage of all annual SBIC investments for many years. For example, in FY 1999, bank-owned SBIC investments were 68% of the $4.2 billion in total SBIC investments made that year. However, with the passage of GLB, banks are now permitted to operate private equity funds without the necessity of SBIC licenses. As a result, less than 5% of dollars now invested by all SBICs is attributable to bank-owned and operated SBICs. Some banks continue to invest funds in Debenture SBICs (generally for CRA credit), but the era of big bank-owned and operated SBICs is over. There are currently 56 bank-owned and operated SBICs managing $1.8 billion in committed capital resources.

3. **The Participating Security program.** The Participating Security program is the newest of the SBIC programs, but it is ramping down out of existence. The program was designed to promote equity investments in small companies. Started in FY 1994, it was the fastest growing of the SBIC programs through FY 2004. At that point the government stopped issuing Participating Security licenses because it was determined by OMB and CBO that Participating Securities are not "debt" securities, a necessity for the program to qualify as a credit subsidy program under the requirements of the Credit Reform Act. As a result of that holding, a dollar-for-dollar appropriation is required for any new leverage. Given the scale of the program ($4.0 billion in leverage committed in FY 2004), that approach has been seen as impossible. The last government-guaranteed Participating Security leverage available will expire September 30, 2008. That unfortunate fact will leave at least a majority of the 166

remaining PS SBICs (managing $11.4 billion in committed capital resources) with no way to complete the business plans that had been approved by SBA in the licensing process.

Second, many of the individuals and institutions that might be inclined to participate in the SBIC program are reluctant to do so because of negative publicity related to what is seen as the government's unreasonable decision to cut monetary support for the Participating Security program after September 30, 2008. Because of that, NASBIC believes strongly that there must be improvement in the SBIC program in two areas. First, we hope to see improvements in the SBA-promulgated SBIC regulations—to make them less onerous to SBICs while still protecting the government's legitimate interests. We are working with SBA on ways to eliminate unnecessary work or expense on both sides and to better align the regulations, where possible, with business norms in the private equity industry of which the SBIC program is a part. Examples of our collaboration this year include elimination of Debenture pre-payment penalties, changes in the calculation of management fees, elimination of time and expense related to what have been identified as unnecessary SBA pre-investment approvals, and an important pending request that SBA change its current interest rate ceilings to better reflect market reality.

No less important is the legislation being considered by this Committee. Enactment of changes in the law that will simplify the program and make it more closely aligned to industry norms will be viewed by industry as proof that Congress still supports the Debenture program and hopes to see it continue to grow and prosper in the future.

With that background, I am happy to say that NASBIC gives its unqualified support to the four SBIC provisions in Title I of the proposed bill. What follows is a brief statement of the reasons for our support.

1. Title I, Section 101: Simplified Maximum Leverage Limits

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

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

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

c. The fact that the leverage cap applies to the whole family of funds can make it impossible for a large successful SBIC to operate a second or third fund due to lack of available leverage because of the leverage cap, not because of any increased risk to SBA based on poor financial performance. If that is the case the management team must raise a non-SBIC fund rather than stay in the program. Once that occurs the likelihood of that management team returning to the SBIC program is very small. With the PS program and the bank-owned program on the wane, this is a critical issue that must be addressed.

d. The proposed bill would solve the problem by making what can be thought of as "transition" leverage available to management teams with more than one SBIC license.

e. As part of the change, the proposed bill would eliminate the CPI inflator for leverage but would set the limits high enough to meet reasonable requirements for the next several years. Also, the absolute limits will make planning easier for both SBA and SBICs alike.

2. Title I, Section 102: Increased Investments in Women-Owned and Socially Disadvantaged Small Businesses

a. NASBIC supports the goal to increase investment capital flows to qualified women-owned and socially disadvantaged small businesses.

b. The SSBIC program once offered special incentives for increasing such investments, but it was eliminated by Congress in 1996 for a variety of reasons.

c. The proposed new incentive (increased leverage availability) is a reasonable approach because it is voluntary and because it does not make what we would consider to be the mistake of requiring 100% allocation to one class of portfolio company. The ability to construct the best possible portfolio of investments from among the widest variety of investment choices is what will keep the SBIC program strong and running at no cost to the government. The proposal recognizes this fact while still providing a strong monetary incentive to help achieve the desired goal.

3. Title I, Section 103: Increased Investments In Smaller Enterprises

a. Current law requires that SBICs with leverage up to $90 million make not less than 20% of their investments in a subset of qualified small businesses defined as "smaller enterprises." Above $90 million in leverage, 100% of investments made using leverage above $90 million must be in "smaller enterprises." There are currently 6 of 134 Debenture SBICs with leverage equal to $90 million or more.

b. This duel tracking requirement is confusing and imposes additional "tracking" workloads on SBA and the few large SBICs that are subject to the requirement.

c. Changing the percentage requirement related to investments in smaller enterprises to a flat 25% for all leveraged SBICs (regardless of whether they have more than $90 million in leverage or not) will increase the number of investments in smaller businesses, simplify program requirements, and reduce workloads and expense for both SBA and SBICs.

4. **Title I, Section 104: Simplified Aggregate Investment Limitations**

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

b. The problem with current law is two-fold: it sets two low a limit under all circumstances, and different leveraged SBICs plan for different ratios of leverage to private capital in their business plans approved by SBA in the licensing process. The projected ratios most often approved in the licensing process are between 1:1 and 2:1. The application of a maximum investment amount based on a percentage of private capital versus a percentage of total capital to be managed by an SBIC produces inconsistent results unrelated to risk.

c. For example, an SBIC licensed with an SBA approved business plan projecting 1:1 leverage would be allowed to invest 10% of its total projected capital—20% of private capital equals 10% of total planned capital at a 1:1 leverage ratio—in a single small business. An SBIC with an approved ratio of 2:1 would only be able to invest a maximum of 6.67% of its total capital in any one small business.

d. This inconsistency has nothing to do with risk management. In fact, industry norms (especially for later stage funds such as Debenture funds) hold that as much as 20% of total capital can be invested in one portfolio company without creating unreasonable risk for the entire portfolio.

e. The current law forces SBICs to invest in more companies than is required under portfolio management theory. The result is less capital available for any one business, especially a business needing more capital to support new growth, and, at least as important, an SBIC management team that is spread too thin to allocate adequate time to individual portfolio companies to help them achieve their growth goals. Time spent by SBIC professionals working on behalf of the companies they invest in is often called as valuable as or more so than the actual SBIC dollars invested in the company.

f. As underscored by testimony of two portfolio company CEOs at the June 21, 2007, roundtable held by the Senate Committee on Small Business and Entrepreneurship, small businesses who need additional capital would rather the same came from an existing SBIC investor than being forced to try to find a new investor to add to the mix.

g. Pending Senate legislation (S. 1662) would address the problem by increasing the limit from 20% of private capital to 30% of private capital. This Committee's proposed bill addresses the problem by reference to 10% of total capital anticipated in the SBA-approved business plan. Either approach would improve the current law. NASBIC suggests the Senate approach might be better for the following reasons. First, 30% of private capital equals 15% of total capital in a fund using only one tier of leverage. This is much closer to the industry norm and might better increase the attractiveness of the Debenture program to prospective management teams. Second, the approach might result in more funds electing to use just one tier of leverage. That would reduce SBA's financial risk.

h. Whatever the approach (and either is better than current law), we ask that the change apply to both current and future SBICs. There is no reason to force current SBICs to labor under restrictions that will not apply to newly licensed SBICs.

The above concludes my remarks on the SBIC provisions of the proposed "Small Business Investment Expansion Act of 2007." In concert with those remarks, we support all SBIC provision in the bill. However, I would like to conclude by suggesting one more provision, one related to the remaining Participating Security SBICs. We propose the following:

Title I, Section 105:

Amend Section 103(9)(A)(ii) of the Small Business Investment Act of 1958 (15 U.S.C. 662(9)(A)(ii) by inserting ", except for any company licensed under section 301(c) on or before September 30, 2004, that holds commitments from the Administration for participating security leverage," before "leverage shall not be funded based on such commitments."

In support of the proposal (included in S. 1662) we offer the following:

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

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

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

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

e. At present, when leverage is drawn it must be supported by paid-in private capital rather than valid, SBA-approved capital commitments by private investors. This means that at a 2:1 leverage plan, $1.00 of private capital must be drawn in to support $2.00 of leverage.

f. The proposal would allow SBICs with valid private investor commitment to draw leverage faster over the next year, reserving private capital to support portfolio companies in the years ahead when leverage will not be available.

g. The private sector commitments would still represent equity supporting SBA-guaranteed leverage and would still be payable to SBA in the event that a fund ran afoul of SBA regulations after a leverage draw. Also, there would be no changes in the requirements that SBICs not be capitally impaired in order to qualify for a draw.

h. While not a complete solution to the problems facing PS SBICs, enacting the proposed amendment might solve a fair percentage of the problem and indicate a government attempt to solve a problem not attributable to any failure by SBICs that face it.

Thank you again for the opportunity to appear before the Committee today. I hope my testimony is of help as you move forward with the proposed "Small Business Investment Expansion Act of 2007."

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Statement of Ron Phillips

President

Coastal Enterprises, Inc.

September 6, 2007

House Committee on Small Business

Hearing on

Legislation Updating and Improving the SBA's Investment and Surety Bond Programs

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Introduction

Thank you, Chairwoman Velazquez, Ranking Member Chabot and honorable members of the Small Business Committee, for the opportunity to testify and contribute to this hearing on the Small Business Administration's New Markets Venture Capital (NMVC) Program. I am Ron Phillips, President of Coastal Enterprises, Inc. (CEI) in Wiscasset, Maine, and one of the founding members of the Community Development Venture Capital Alliance (CDVCA), the national trade group we formed in 1993 to promote the practice and policy of socially-targeted venture capital investing. I am also board chair of CEI Community Ventures, Inc., which manages our SBA-sponsored NMVC fund, so I am pleased to represent all of these entities with respect to these hearings.

Chairwoman Velazquez, I thank you for your leadership in seeing the initial NMVC program authorized and Congressman Chabot, I am pleased that one of my fellow NMVC companies, Adena Ventures, has been putting the NMVC program to work throughout your home state of Ohio and through parts of Kentucky and West Virginia.

I would also like to acknowledge Congressman Mike Michaud, who has been a strong supporter of CEI over the years and a partner in our work to support businesses and communities throughout Maine. One of the issues with which we've been most concerned with in Maine is access to smaller-scale and creatively managed venture capital. Maine is a small business state, with 90 percent employing fewer than 20 individuals. Access to smaller-scale venture capital, the driving purpose of our initial desire to launch the NMVC program, is as valid today as ever. I want to thank the Congressman for his support and advocacy for resources to benefit Maine and other rural and urban regions of the U.S.

I would also like to acknowledge Congresswoman Gwenn Moore, who has been an outspoken advocate of the New Markets Venture Capital program and who gave an energizing and impassioned speech at this year's CDVCA conference here in DC. We know that she is concerned as is many in Congress for the decline in U.S. manufacturing and loss of jobs to overseas operations. Although a small step for a very large problem, I'm glad to report that over 50 percent of the funds invested by the community development funds

operating in the United States are going into manufacturing businesses according to CDVCA.

As my following comments will hopefully show, much success lies behind the NMVC program, but much more awaits us in the future. Accordingly, I'm here today to urge bipartisan support of the Committee's bill which would extend and reauthorize the NMVC program. We hope there is bipartisan support for moving a strong reauthorization bill through Congress so we can see the program grow and see new NMVC companies certified in urban and rural areas across the country.

First, let me say a word about CEI. Founded in 1977, we are a nonprofit community development corporation (CDC). In 1996 we were certified among the first community development financial institutions (CDFI). In 2002 we were certified as a community development entity under the NMTC program, and are currently one of the largest allocatees under that program financing projects largely in the rural Northeast. This region also overlaps with our license as an SBA-sponsored NMVC company, which we received in March, 2003. With SBA support CEI also operates several other programs in Maine: Since the mid-1980s we've been a Small Business Development Center and SBA 504 packager, and in 1992 launched the very successful SBA Microenterprise Program and are the state's largest intermediary lender. We also operate Maine's Women's Business Center.

All of these programs and our impact as an organization are due in great measure to the SBA. We are now one of the oldest CDC/CDFIs in providing capital and technical assistance to primarily rural regions of Maine to foster the growth of natural resources industries, small and micro businesses, affordable housing, and community facilities, such as child care. In recent years CEI has expanded geographically with its venture capital and NMTC financing to include rural New England and upstate New York. Our NMVC company is targeted to eligible census tracts in primarily rural northern New England. With over $370 million in capital under management, and one of the country's largest allocatees of the New Markets Tax Credit program, about ten percent of our capital investment is dedicated to venture capital, which brings me here today.

Through one of our for-profit venture capital subsidiaries, CEI Community Ventures, Inc., we manage over $10 million in the SBA-sponsored New Markets Venture Capital program, and $3 million in Operational Assistance grants. Combined this program sets the stage for effective delivery of flexible equity and technical assistance funds to primarily early-stage ventures in hard to reach markets and underserved communities. Half of the funds must come from private investors and we're pleased to note that TD Banknorth, the Ford Foundation, the MacArthur Foundation, Sandy River Charitable Foundation, Maine Employee Insurance Corporation, and Vermont Community Foundation joined CEI in creating the necessary $5 million in private capital to match the SBA's debenture commitment.

In addition, the companion $3 million in Operational Assistance grants provided through the NMVC initiative enabled CEI to provide technical assistance to these starting and early stage companies in the NMVC portfolio. Being able to provide this support to our companies is a vital component in our community development strategy. CEI went to a

variety of sources to secure the matching funds required in order to secure the Operational Assistance funding from SBA. Sources of CEI's match included the Surdna Foundation, Chittendon Bank, the New Hampshire Community Development Authority and the Yale/Goldman Sacks Best Business Plan Competition as well as in-kind support that was provided by several independent accounting and law firms.

Now I would like to offer comments in three areas: First, I want to provide some background on CDVCA, its role in advocating for the NMVC legislation and the community development venture capital industry, and the impact of six NMVCs, based on a recent survey. Secondly, I will discuss CEI's experience as one of six New Markets Venture Capital Companies certified by the SBA, describe some of the businesses that have benefited from the financing and the operational assistance we have provided, and detail why we feel it is so important that the NMVC program be reauthorized. And finally, I will touch on a few technical changes that are being proposed for the program in the Committee's bill and why I think they are important.

Community Development Venture Capital Industry

CEI was a founding member of CDVCA, the trade association for domestic and international community development venture capital funds. With backing from the Ford and MacArthur Foundations, CDVCA was organized in 1993 to apply the tools and discipline of venture capital investing to create jobs, build entrepreneurial capacity and generate wealth to benefit low-income individuals and economically distressed communities.

CDVCA has been involved with the NMVC program from the beginning and worked closely with the Small Business Administration and Congress to craft an initiative designed to support the goals of the community development venture capital industry – namely to ensure that patient venture capital and operational assistance is made available to businesses operating in poor communities.

While modeled after the SBA's Small Business Investment Company (SBIC) program, the New Markets Venture Capital program is unique in three ways:

1. It targets venture capital investments to high-growth small businesses in poor urban and rural areas;
2. It ties investments to the creation of local jobs with livable wages and benefits for low-income individuals; and
3. It provides supplementary technical support to give potential and portfolio companies a boost in their business operations, a vital resource for small funds such as the NMVC.

These are not explicit goals for SBIC financing and I believe it is critical that the SBA have a program in its portfolio that <u>does</u> intentionally target venture capital to businesses operating in distressed areas.

NMVC History and Rescission

Congress enacted the NMVC program in December 2000 as part of the Consolidated Appropriations Act of 2001 (P.L. 106-554). The NMVC program was part of a broad bipartisan initiative to target federal assistance to improve local economies in low-income urban and rural communities. The other elements of the effort included in the Community Renewal Tax Relief Act were the New Markets Tax Credit program, additional empowerment zones and a new program called Community Renewal Zones.

In FY 2001, Congress appropriated $22 million as subsidy to support $150 million in debenture guarantees and $30 million in operational assistance grant financing to support up to 15 NMVC companies. Half of this money was obligated to support six NMVC companies that were designated by the SBA in July 2001. In the fall of 2002, SBA agreed to designate seven additional funds in 2003. However, Congress rescinded the remaining monies - $24.25 million - in the Fiscal 2003 Omnibus Appropriations Bill.

Impact of NMVC Companies

Though the reach of the NMVC program was scaled back with the recession of fund for the second round of NMVC Companies, the 6 existing NMVC companies, have demonstrated the effectiveness in using debenture and operational assistance grants to find and invest in strong, high-growth companies in low-income, underinvested areas that can generate market-rate returns for investors and foster economic growth and job creation in some of the country's most distressed urban and rural communities.

Let me offer some impact statistics based on a survey of the NMVC companies conducted by CDVCA in March of 2006. While the accomplishments of the NMVC companies have multiplied since CDVCA's survey was completed over a year ago, the data collected through the survey demonstrates the potential that the NMVC program as a tool to generate community development venture capital activity in poor communities.

As of March 2006:

- The six NMVC companies had invested more than $48 million in 75 companies all based in low-income communities, with 53% of these investments in manufacturing, agriculture, forestry and fishing enterprises, a positive sign in an age of outsourcing and loss of U.S. manufacturing jobs;
- Virtually all of the capital has been invested in seed, early and expanding companies, and very little in later stage;
- At $1.7 million the average size of the NMVC investment has been on average five times smaller than the average of $9 million over the same period;
- NMVC companies used the $48 million invested to leverage an additional $136 million in investments in the companies and the additional investments were generated from both individual investors as well as other venture funds;

- NMVC companies had provided more than $6 million in operational assistance grants to 163 companies to fund such things as a business plan that plotted the success of a Vermont importer of organic fair trade products and a business plan for a Maine software business that used the plan to secure a $1.2 million equity investment; and
- NMVC companies had created 368 new jobs and maintained another 1,626 jobs that were at risk.

CEI's Experience as a New Markets Venture Capital Company

Let me go right to the heart of the matter. Despite the size of the U.S. venture capital industry overall which represents more than $500 billion and is the envy of the world , access to flexible, socially-targeted venture capital is very limited. When we describe our venture industry as socially-targeted, we often refer to a double if not triple bottom line of economic return: social return in the form of good jobs and even stock ownership opportunities for workers and, increasingly, a return on responsible environmental practices. This latter point is particularly timely in view of climate change and challenges to industry on a global scale.

Our CDVCA industry calculates that the targeted share of socially-responsible venture capital as less than 2% or about $900 million. I would point out that despite this dramatic disparity in the market there has been a gradual but steady increase in the venture capital directed to low-income communities since the initial CDVCA funds were forming in 1990.

With amounts ranging from $300,000-$750,000, and current sales levels projected for 2007 at $40 million, CEI's Community Ventures Fund (CCVF) portfolio consists of eight small ventures that are positioning for growth and impact. We are fully invested now with $5.8 million and $1.6 million reserved for follow up investing. These funds leveraged over $20.6 million in additional institutional equity and $7 million in individual investing for a total of $26.3 million. Leverage of our equity isn't the only attribute of a NMVC company. These institutions and individuals also provide extra help, guidance, contacts and networks to help the company succeed. Our average ownership is 26 percent and, all things being equal in the venture world – and despite the failure we've already had, common for a fund - we project exit opportunities at various junctures sufficient to pay off the SBA, and return capital to investors with some to spare. In a word, a successful fund, leverage of funds, job impact, and future for many people and places are left out of the economic mainstream.

In addition to investing, CEI's Community Ventures Fund (CCVF) has contracted out and provided direct technical support to 16 companies totaling some $2.3 million. Funds have been used for a range of purposes including business plans tailored to venture investing needs, software accounting, marketing and branding, website development, executive search, public relations and trade shows. CEI will use its remaining Operating Assistance grant funds to provide ongoing assistance and support to these companies.

What are some of the companies in which we've invested? You may have already encountered one or more of the "brands" of CCVF portfolio companies in the market place.

For example, if you went into one of CVS' 6,000 stores to purchase a natural skin care lotion, BeFine, the vision of entrepreneur Florence Sender, now based in Newton, MA might be your choice. Or if you like ravioli pasta with wholesome, natural ingredients, it may be Putney Pasta, again started by a woman now based in Brattleboro, Vermont; or then again, women's specially-designed sportswear under the ISIS brand of Juno Rising, also co-founded by two women, Carolyn Cooke and Penelope Gall, in Burlington, Vermont. Or perhaps when shopping at Whole Foods and other outlets of quality, organic foods you'll note Rustic Crust, a Pittsfield, NH small venture with big visions. Brad Sterl, CEO and founder, known as the "Crust Crusader", is bringing his culinary skills to the wider consumer market and preference for a high-end natural, old world crust pizza. But software companies or new technology ventures are also part of our portfolio. We've invested in NanoComp Technolgies, a Concord, NH based start up which is commercializing carbon nanotubes technologies for use in high-performance textiles.

Let me focus on just one of our companies, Look's Gourmet in Whiting, Maine, processor of natural fish and clam chowders, lobster Newburg, herring fillets and a variety of other canned and bottled seafood sauces and products under the Bar Harbor brand. With a sales growth of 208 % between 2003 and 2006, Look's Gourmet was recently selected by *Inc. Magazine* among the top 35% or 1,742 of the 5,000 fastest growing small firms in the U.S. Whiting is a rural village of 2,200 population located in Washington County which, besides being the first county on which the sun first rises in America, is also among the poorest. New business and job opportunities are challenging, so when a venture emerges with promise of growth, employment and economic opportunity, it's our job to provide the type of equity capital and technical support to help the company realize that potential. The headline in the regional newspaper says it all. With a photo of the processing building on Holmes Bay, it reads "Gourmet Canning Company Expands Facility and Increases Sales Using Lean Principles: Seven New Jobs Added: Entrepreneurial Spirit Takes Hold." (*Ellsworth American*, week of February 6-12, 2007)

Mike Cote, Maine native and entrepreneur, acquired the 100 year-old company and moved to "Downeast" Maine where the company was located and set about to realize the potential he saw in a natural product blended with the character and tradition of Maine's fishing heritage. As an executive with Pepperidge Farms and Odwalla, Inc. Mike brought a lot of experience in the food processing, sales and marketing industry. With help from CCVI's equity commitment and Operational Assistance funds, he began the process of reshaping the company's brand, labeling, market strategy and business goals to achieve a greater economic potential that was dormant. They've now doubled employment to 26 in a geographic region offering few options for jobs.

With multiple seafood Canneries once dotting the Downeast coast line, the once busy canning landscape is all but gone with the exception of one company with a vision, mission and a plan to bring great local seafood products and traditional seafood soups and sauces to the world. To accommodate this plan required the utilization of local remaining experienced workers in the canning arena and the ability to attract a few who had worked a lifetime in the industry, but were forced to leave Maine for employment opportunities elsewhere. Here's what Mike Cote would say:

> *We tapped into local talent first and began to look outside our own circles for the talent once available in this area and were able to bring back a family of four, residing and working in Florida, reuniting them with their families and with the promise of solid jobs and a future with a fast growing company. Employees in this area are naturally wary of opportunities, as they have seen many come and go. It's important to involve your employees in the process of change, sharing your vision for them and the company as we continue to build success here in Washington County.*

The ingredients for success include not just the natural products of clam chowder, lobster bisque, and wild herring fillets, but the intangible value of an entrepreneur matched with appropriately scaled and responsive venture capital. And the value of this company doesn't stop there, or the direct jobs they're creating. A local crafts person under the brand "artful wares" sources clam, mussel and lobster shell wastes as a natural base for production of flatware and accessories, yet another way to bring this brightly colored and rich heritage of Downeast Maine to the dinner table. Look's Gourmet recently brought in a second wave of investors beyond Maine's borders, among them a private, foundation-backed venture firm from the West Coast called Sea Change which specializes in investing in sustainable marine industries. Again, as Mike Cote put it,

> *When attracting capital for a fast growing business, it's important to balance the investor portfolio with investors whose mission is aligned with your core company principles. In this case, the Sea Change/SEGF investment brings balance to our current investor portfolio and allows us to drive forward on our mission to create a company and brands that brings forth one more element of social consciousness, i.e. sustainability".*

Google any of the companies I've mentioned and you'll be able to learn more and even order products directly from the web.

Recommendations

On behalf of my colleagues in the community development venture capital industry, I would like to strongly encourage the Committee to reauthorize the NMVC program. I think the structure of the current program is sound and designed in a way that allows community development venture funds to pursue socially-targeted venture capital investing in poor communities.

That said, I would like to suggest that three technical changes be made to the current NMVC statute and I thank the Committee for incorporating these changes in the Committee's draft bill.

First, we recommend that the definition of "Low-Income Geographic Area" within the NMVC statute be aligned with the definition of "Low-Income Community" as defined in the New Markets Tax Credit (NMTC) statute (IRC Sec 45D).

First, we recommend that you amend current law to align the definition of "Low Income Geographic Area" within the NMVC statute with the definition of "Low-Income Community" as defined in the New Markets Tax Credit (NMTC) statute (IRC Sec 45D(e)). This change would have an immediate impact on CEI as well as Kentucky

Highlands Investments Corp since both entities are NMVC companies as well as New Markets Tax Credit allocatees that under current law find it difficult to use the two programs together because of disconnect in the targeting requirements. Ensuring that those areas eligible for NMVC investment are also eligible for NMTC investments will allow NMVC Companies to combine the resources and leverage the impact they can have in targeted communities and with targeted businesses.

In 2004, the original NMTC statute was amended to allow for the targeting of investment benefits to both low-income 'target populations' as well as low-income census tracts and making this change would allow NMVC companies to target investments to benefit low-income individuals as well. The flexibility to target low income populations as well as a low income census tract is particularly important for organizations working in rural areas where poverty rates and median incomes do not necessarily reflect the pockets of poverty located in a community.

Secondly, we recommend that the current NMVC statute be amended to ensure that conditionally approved NMVC companies have a full two years to raise the private capital required to secure final approval, Twenty-four months is typically the minimum time needed to raise the capital required by law and we ask that the statute be clarified to grant NMVC companies the full 24 months needed. This change, if adopted, would only apply to future NMVC funds when the program is reauthorized, since all six of the current NMVC companies have raised their capital.

And thirdly, with respect to the operational assistance grant funding, we recommend that the Committee eliminate the provision that requires an NMVC companies to provide a cash match in order to secure and operational assistance grants. We suggest that the Committee instead put in place a formula that bases the size of a NMVC's operational assistance grant on the amount of private investment capital raised by the NMVC company. Specifically we suggest that the NMVC formula be modeled after the Rural Business Investment Company (RBIC) program which is jointly administered by the SBA and the USDA. The RBIC program is similar in structure and purpose with the NMVC program but under the RBIC program a participating Rural Business Investment Companies receives an operational grant that is equal to ten percent of the private capital raised by an RBIC or $1 million, whichever is less. Such a formula simplifies the current NMVC program and provides a great deal of relief to NMVC companies that find it difficult to raise the private match for operational assistance funds.

Conclusion:

As I said in the beginning of my remarks, much success lies behind us, but much more awaits us if the Committee's bill would extend and reauthorize the NMVC program. In Maine and other regions throughout the U.S., the good news is that local communities and states are doing their share to evaluate their assets and build on their competitive advantage in a globalized economy. Federal resources can contribute to these local initiatives, helping to encourage the private sector to step in and step up.

In Maine, for example, we count a dozen specialized industry sectors where Maine can, with the right mix of entrepreneurs and flexible equity capital, do much more. These include advanced composite construction in the boat building industry, a 400-year history in the state; large-scale eco-tourism facilities' development in Maine's North Woods, including world-class cross country skiing center: huts and trails modeled on successful European ventures; food processing capturing the state's agricultural and marine industry products; and specialty paper, despite the highly competitive paper and pulp industry here and abroad.

We hope there is bipartisan support for moving a strong reauthorization bill through Congress so we can see the program grow and see new NMVC companies certified in urban and rural areas across the country.

Thank you for this opportunity to talk with you this morning about the NMVC program and reauthorization.

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