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SMALL BUSINESS VENTURE CAPITAL ACT OF 2007

OCTOBER 16, 2007.—Ordered to be printed

Mr. KERRY, from the Committee on Small Business and Entrepreneurship, submitted the following

R E P O R T

[To accompany S. 1662]

The Committee on Small Business and Entrepreneurship, to which was referred the bill (S. 1662) to amend the Small Business Investment Act of 1958 to reauthorize the venture capital program, and for other purposes, having considered the same, reports favorably thereon with an amendment in the nature of a substitute and recommends that the bill do pass.

I. PURPOSE AND NEED FOR LEGISLATION

The purpose of the "Small Business Venture Capital Act of 2007" is to reauthorize and improve the Small Business Administration's (SBA) Small Business Investment Company (SBIC) program and the New Markets Venture Capital (NMVC) program so that more small businesses, in number and diversity, have access to venture capital. This type of financing is important because it provides patient capital to firms that show significant growth potential but need time for the business to mature without the burden of monthly debt payments. As Dr. Jeffrey E. Sohl, Director of the Center for Venture research at the University of New Hampshire's Whittemore School of Business and Economics, pointed out to the Committee during a June 21, 2007, roundtable, "debt servicing is money that is going out the door." Ideally, he says, "the angels and equity dealers at the early stage are in there for a good five to seven years," because small businesses need "all the money to stay

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with the company and to fuel the growth for the company."[1] Moreover, as explained by former Federal Reserve Board Chairman Alan Greenspan: "Credit alone is not the answer. Businesses must have equity capital before they are considered viable candidates for debt financing * * *. Continued efforts to develop markets for private equity investments will be rewarded by an innovative and productive business community. This is especially true in lower-income communities, where the weight of expansive debt obligations on small firms can severely impede growth prospects, or more readily lead to business failures."[2]

Venture capital is a critical driver of our economy and job creation, as well as an essential component in the continuum of small business financing; it is, therefore, a necessary function of the SBA. While there is sufficient capital in the market available for investment, small businesses may have difficulty accessing these funds, as venture capitalists only act on one out of every 300 or 400 deals they see.[3] Traditional venture capitalists focus primarily on high-technology segments and larger, later-stage deals, concentrated heavily in just five states (California, Massachusetts, New York, Texas, and Colorado), and they are looking for faster and larger returns on their investments.[4] More specifically, traditional venture capitalists typically make investments of $7 million with exits within three to four years, instead of deals of less than $3 million in which investors are willing to stay for five to seven years. According to Dr. Sohl and Dr. Julia Rubin, who also participated in the Committee's roundtable on June 21, 2007, there is a dramatic need for deals that range from $50,000 to $1 million, even for deals from $1 million to $3 million, as well as for deals in low-and moderate-income rural and urban areas and equity for seed money and startups. Finally, data from the SBA and the National Black Chamber of Commerce and the U.S. Hispanic Chamber of Commerce make clear that there is also a need for venture capital managed by and invested in firms owned by minorities.

The SBA's programs help to fill many of the gaps identified above and, therefore, need to be continued. The Agency's SBIC program targets investments between $250,000 and $5 million. In FY2006, 40 percent of their investments were in low- and moderate-income areas and 30 percent of their dollars went to firms that had been in business only two years or less. Whereas traditional venture capitalists concentrate their investments in companies in communications, computers and life sciences, approximately 50 percent of SBIC funds go to a more diverse segment of businesses, including manufacturing and consumer-related businesses. Moreover, SBIC investments impact more parts of the country. While traditional venture capitalists make most of their investments in California and Massachusetts, SBICs have made as much

[1] Roundtable on "SBA Reauthorization: Small Business Venture Capital Program" Before S. Comm. on Small Business & Entrepreneurship, 110th Cong. Page 10 (2007) (Transcript of Proceedings).

[2] Federal Reserve System Research Conference on Business Access to Capital and Credit, March 1999.

[3] Roundtable on "SBA Reauthorization: Small Business Venture Capital Programs" Before S. Comm. on Small Business & Entrepreneurship, 110th Cong. Page 13 (2007) (Statement of Dr. Julia Rubin, Professor, Edward J. Bloustein School of Planning and Public Policy, Rutgers University, Transcript of Proceedings).

[4] Community Development Venture Capital Alliance, The New Markets Venture Capital Program, Providing Equity Capital and Expertise to Entrepreneurs in Low-Income Urban and Rural Communities, 4 (January 2007).

as 71 percent of their investments outside of those two states. Since the program was created in 1958, SBICs have provided approximately $48 billion of long-term debt and equity capital to more than 100,000 small firms, with $2.9 billion invested in more than 2,000 companies in FY2006 alone. Many of the companies have gone on to become household names, including Intel, Callaway Golf, Jenny Craig, Outback Steakhouse, and Federal Express.

SBA's NMVC program addresses the market gap in venture capital for companies located in low- and moderate-income rural and urban areas, as well as the need for smaller deals that neither traditional venture funds nor the SBIC program will make. By law, NMVC funds are obligated to make 80 percent of their investments in such areas, but, in FY2006, they surpassed that target by making 92 percent of their investments in those areas. Their investments are longer term, ranging from three to seven years, and their deals range from $500,000 to $1 million. As Mr. Ray Moncrief, the Executive Vice President and Chief Operating Officer of Kentucky Highlands Investment Corp. in London, Kentucky, and a manager of both an SBIC fund and an NMVC fund, explained at the Committee roundtable on June 21, 2007, most traditional venture capitalists will not do deals of $750,000 or less because of prohibitive transaction costs. However, such deals can be done through the NMVC program because it is structured with an SBA-backed debenture and an operational assistance grant to offset the expensive cost of intensive technical assistance to a portfolio company. Those incentives allow the industry to attract experienced venture capitalists who could potentially make many millions of dollars elsewhere. Attracting that level of expertise, in turn, helps to attract investors to a field that does not yet have a track record for investments in these areas. Six NMVC companies were formed and began investing in 2003 and 2004, and, as of June 2007, the Community Development Venture Capital Alliance reported that NMVC companies have invested more than $48 million in 75 companies, all based in poor, under-invested areas. They have leveraged $136 million in investments from other sources, provided more than $6 million in operational assistance to 163 companies, created 368 quality jobs with health care and benefits, and created or maintained more than 1,600 jobs.

II. SUMMARY

S. 1662, the "Small Business Venture Capital Act of 2007," incorporates S. 1663, the "Securing Equity for the Economic Development of Low Income Areas Act of 2005," or "SEED Act," and reauthorizes through 2010 the Small Business Investment Company Debenture and Participating Securities programs and the New Markets Venture Capital program. There are four objectives of S. 1662: (1) to simplify the SBIC Debenture program so that it is more attractive and beneficial to investors; (2) to tweak the SBIC Participating Securities program so that the last operating funds have the flexibility to maximize follow-on investments as the program is phased out; (3) to encourage investment in firms owned by minorities and women; and (4) to use the changes to restore the reputation of and confidence in the SBIC program. S. 1663, as incorporated into the Small Business Venture Capital Act, modifies

the NMVC program's targeted investment area (the definition of low-income community) to mirror the New Markets Tax Credit program; eliminates the matching requirement for the operational assistance grants to mirror the U.S. Department of Agriculture's community development venture capital program for rural areas; and, clarifies that conditionally approved NMVC companies have a full two years to raise the required private capital.

III. HISTORY OF LEGISLATION AND VOTES IN COMMITTEE

The SBIC program was originally created almost 50 years ago, with the enactment of the Small Business Investment Act of 1958, P.L. 85–699 (Aug. 21, 1958). Passage of the Act addressed concerns raised in a Federal Reserve Board report to Congress that there was a major gap in the capital markets for long-term funding for growth-oriented small businesses. Facilitating the flow of capital through the economy to pioneering small concerns in order to stimulate the U.S. economy was and remains today the main goal of the SBIC program. Congress needs to reauthorize the program because the Small Business Investment Act, which governs the program, has outdated authorizing language (from 2006), leaving the program to operate under appropriations bills and a temporary SBA authorization that expires on December 15, 2007.

The NMVC program was introduced in 1999 by Senator Kerry and enacted as part of the 2001 Consolidated Appropriations Act (S. 1594/P.L. 106–554). The NMVC program addressed concerns that, while most of the country was prospering, there were still areas which suffered from chronic unemployment and high poverty rates. The purpose was to take the power of venture capital that had transformed the economies of Silicon Valley in California and Route 128 in Massachusetts and use it to transform local economies in low-income rural and urban communities. Based on the SBA's successful SBIC program, the legislation's goal was to create a separate program that delivered a double bottom line: economic and social returns. The program needs to be reauthorized because it has a sunset date of September 30, 2006, and is currently operating under a temporary SBA authorization that expires on December 15, 2007.

The "Small Business Venture Capital Act of 2007" (S. 1662) was introduced by Senator Kerry, for himself and Senator Snowe, on June 19, 2007. As introduced, the bill reauthorizes the SBA's venture capital programs under the Small Business Investment Company (SBIC) program. During the markup of the bill, the Committee unanimously adopted by voice vote a bipartisan managers' substitute amendment offered by Chairman Kerry for himself and Ranking Member Snowe. The substitute amendment incorporated S. 1663, the "Securing Equity for the Economic Development of Low Income Areas Act of 2007," or "SEED Act," a bill to reauthorize the New Markets Venture Capital (NMVC) program. It also made clarifications and changes to the bills as originally introduced based on feedback from participants of the small business venture capital roundtable held on June 21, 2007. The bill was subsequently adopted as amended by a roll call vote of 19–0.

S. 1662 incorporated some of the SBIC provisions adopted by the Committee in the 109th Congress as part of S. 3778, the "Small Business Reauthorization and Improvements Act of 2006," which

Senator Snowe, then chair of the Committee, introduced on August 2, 2006. That bill was reported out of the Committee unanimously, by a vote of 18–0, but was never considered by the full Senate before the adjournment of the 109th Congress.

S. 1663 incorporated NMVC provisions that originated in the 108th Congress, as Senator Kerry proposed them for inclusion in S. 1375, the "Small Business Administration 50th Anniversary Reauthorization Act of 2003." They were adopted by the Committee and passed by the full Senate but were not included in the provisions that were attached to the 2005 Omnibus Appropriations Act because of objections by the SBA. Many of the measures were then reintroduced by Senator Kerry in the 109th Congress as the "Securing Equity for the Economic Development of Low-Income Areas Act of 2006," or "SEED Act" (S. 3680), which was cosponsored by Senators Bayh, Landrieu, and Lieberman. Some of the provisions in S. 3680 were included in the Committee's comprehensive reauthorization bill, S. 3778, which, as noted in the preceding paragraph, was reported out of the Committee unanimously but was never considered by the full Senate before the adjournment of the 109th Congress. The SEED Acts in both Congresses were companion bills to H.R. 4303 and H.R. 1719, respectively, introduced by Congresswoman Gwen Moore of Wisconsin and Congressman Harold Rogers of Kentucky.

SBA's venture capital programs and the provisions in S. 1662 and S. 1663 were deliberated in a series of hearings and roundtables in the 109th and 110th Congresses.

On March 9, 2006, during the hearing to examine the SBA's Fiscal Year 2007 budget and the SBA's proposed legislative package for reauthorization, the Committee questioned the rationale for the Administration's proposal to impose administrative fees on the small business participants of the 7(a) Loan Guaranty program, the 504 Loan Guaranty program, and the Small Business Investment Company program. These proposals were controversial and were not adopted by the Committee.

On February 28, 2007, the Committee held a hearing to review the SBA's Fiscal Year 2008 budget. In addition to concerns about frozen program levels for the credit programs, including SBICs, some members were opposed to zero funding for the NMVC program for the seventh consecutive year, particularly considering that the Administration at the same time proposed a new, separate New Markets program, described as the "New Markets Tax Credit Pilot Loan program." Senators Kerry and Snowe were successful in passing an amendment to the FY2008 Budget Resolution (S. Con. Res 21) that provided funding for the New Markets Venture Capital program. There was concern about the lack of a proposal or funding for an initiative to reform the Participating Securities program. Members were glad to see that the Administration did not recycle the previous year's proposal to impose an administrative fee on the SBICs, and they were cautious about the budget's proposed fee reductions for SBIC debenture deals because there was concern about how the Agency would implement the reduction while keeping the program at zero subsidy.

On April 26, 2006, the Committee held a hearing on the "Reauthorization of SBA Financing and Economic Development Programs." The Committee heard from lenders, small business stake-

holders, and SBA representatives on the benefits of SBA's loan and venture capital programs and evaluated legislative proposals that were incorporated in S. 3778, the "Small Business Reauthorization and Improvements Act of 2006."

On June 21, 2007, to complement the reauthorization hearing held on April 26, 2006, the Committee held a roundtable, "SBA Reauthorization: Small Business Venture Capital." The purpose was to discuss the state of venture capital for small businesses, the venture capital needs of small businesses, the strengths and weaknesses of the SBIC and NMVC programs, and the provisions in S. 1662, the "Small Business Venture Capital Act of 2007," and S. 1663, the "SEED Act." The participants included small businesses that had received venture capital through the SBIC or NMVC programs, managers who run SBIC or NMVC funds, experts in the field of developmental venture capital and equity for small businesses, and representatives from the Small Business Administration, the National Black Chamber of Commerce, and the U.S. Hispanic Chamber of Commerce.

Finally, on May 22, 2007, the Committee held a hearing entitled "Minority Entrepreneurship: Assessing the Effectiveness of SBA's Programs for the Minority Business Community." As part of reauthorization, the Committee has tried to address complaints from minority business owners and organizations representing minorities that SBA's programs do not effectively meet the needs of these entrepreneurs and that the SBA needs to use its economic development tools to help close the wealth gap between whites and minorities. The Committee discussed the need to increase the share of loans to minorities, which has remained largely stagnant since 2001, to increase the SBIC investments in firms owned by minorities, and to increase the licensing of SBIC funds to minorities because, according to the SBA's data, they have been declining since 1998.

IV. DESCRIPTION OF BILL

The "Small Business Venture Capital Act of 2007" reauthorizes the SBIC Debenture program, the SBIC Participating Securities program, and the New Markets Venture Capital program through 2010. The SBIC Debenture program is reauthorized to back leverage commitments of $2 billion in FY2007, $2.25 billion in FY2008, $2.5 billion in FY2009, and $2.75 billion in FY2010. Based on estimates from the National Association of Small Business Investment Companies (NASBIC), this should keep pace with current investment levels of SBIC Debenture funds and leave room for growth. The New Markets Venture Capital program is reauthorized to back $150 million in debentures, the same level that is currently authorized by law. In addition, the legislation reduces from $30 million to $20 million the authorization level for operational assistance grants. The Committee estimates that $150 million in debentures would allow the SBA to license up to 20 new NMVC companies and that the $20 million in operational assistance grants would allow the SBA to provide each of those companies with up to $1 million in operation assistance funding. The bill authorizes the SBA to back up to $500 million in SBIC participating securities in each of fiscal years 2007, 2008, 2009, and 2010. The Committee debated whether to provide new authority for the SBIC Participating Secu-

rities program because it is being phased out and is all but certain not to need the authority. Not only will the SBA not license new funds, but it is too expensive to fund any new activity (OMB has concluded that the program no longer meets the Federal Credit Reform Act standards and therefore requires a dollar of appropriations for each dollar of Participating Securities leveraged). Nevertheless, many on the Committee believe that there remains a need in the market for smaller equity investments to small businesses and want to see the program reformed, rather than eliminated. Some of those proponents thought it was important to signal to the investment community that there was still support in Congress for the SBIC program.

Instilling confidence in investors and potential investors in SBA's SBIC programs was a priority for the Committee, and, therefore, partial justification for all of the SBIC program changes in this bill. The Committee agrees that the SBIC Participating Securities program has flaws in its current structure, leading to what the SBA estimates will be $2.8 billion in losses by the time all the funds have expired. However, many on the Committee do not agree that the program, or other iterations of the program, as adopted by the Committee in the 109th Congress or proposed by industry, does not meet Federal Credit Reform Act Standards. The lack of cooperation and lack of transparency in assessing losses and determining what meets the test of Federal Credit Reform led the private sector to conclude that SBIC commitments with the SBA were unreliable and one-sided, in favor of the government.

In addition to restoring the confidence of the private sector in the SBIC program, the bill seeks to make the program more attractive in several ways. It simplifies the rules regarding the maximum amount of outstanding leverage allowed for funds. Currently, the maximum amount of leverage available to a management team from the SBA is determined by a complex formula that is adjusted annually based on the Consumer Price Index (CPI). The amount is the same whether the team has one fund or multiple funds. For FY2007, the maximum amount of leverage for one fund is $127.2 million. Adjusting the level each year to the CPI has proven to be tedious for the SBA and for the fund managers. To simplify the limitation and return some oversight to the Congress, the bill eliminates the CPI adjustment and assigns a fixed-dollar amount of $150 million for one fund and a separate $225 million limit for multiple funds under common control. Currently, SBA allows multiple SBIC funds commonly controlled to exceed the maximum leverage amount on a case-by-case basis. According to the SBA, the requests are approved the majority of the time. Raising the amount would streamline the process, saving time and money for the SBA and the funds. Furthermore, it would accomplish this without increasing the risk of taxpayer money, since the SBA retains the right to reject any request to draw leverage if the fund is not in good standing. Because the approval process for a license is so rigorous, a fund that is approved for an additional license is assumed to be astute enough to make investments over the maximum amount. This change could also encourage successful fund managers to apply for a second fund because they would have access to what the industry refers to as "uninterrupted capital" for new

investments as they are winding down the previous funds and repaying that leverage.

In a combined effort to simplify the program and to encourage investments in small businesses that are owned by minorities or women or that are located in a low-income area, S. 1662 increases the maximum leverage amount for a single fund from $150 million to $175 million and, for multiple funds under common control, from $225 million to $250 million. This change is important to address concerns among Committee members that, since 1998, the share of investments in firms owned by minorities and women has gone down. For example, in 1998, the share of financings that went to firms owned by minorities was 26 percent. In 2004, the most recent data available, the share dropped to 10.58 percent. For that same time frame, the share of financings to women dropped from 6 percent to 2.96 percent. At the roundtable, both the National Black Chamber of Commerce and the U.S. Hispanic Chamber of Commerce spoke out against or submitted comments against the absence of SBIC companies managed by African Americans or Hispanics.

In order to simplify the administration of the SBIC program while increasing the percentage of investments in smaller enterprises (net worth of $6 million or less and average net profit over two years of $2 million or less), the Small Business Venture Capital Act eliminates the current law's two-tiered formula for a flat rate. Currently, firms that leverage $90 million or less must invest a minimum of 20 percent in smaller enterprises. Firms that leverage more than $90 million must invest 100 percent of every dollar over the $90 million threshold in smaller enterprises. According to the industry, this system has made it hard to keep records, therefore creating an unnecessary workload for the SBA and the funds. To correct this inefficiency, the bill establishes a flat 25 percent requirement that funds must invest in smaller enterprises. Because SBA estimates that the majority of funds are $90 million or less, the Committee believes that, on balance, this change will result in a greater share of investments in smaller enterprises.

To make the SBIC and NMVC programs more attractive to investors, more helpful to small businesses, and to bring them more in line with private-sector practices, S. 1662 increases the maximum percentage of private capital that an SBIC or NMVC company may invest in one company from 20 percent to 30 percent. Typically, private investors place 20 to 25 percent of their entire capital in one company. However, because SBIC companies have three different leverage ratios available to them—1:1, 2:1, and 3:1—(NMVC companies typically use a 1.5:1 leverage ratio) the 20 percent limit in practice equates to a much smaller percentage. For example, a 1:1 fund would end up with only 10 percent of its total capital available for one investment and a 2:1 fund would end up with a maximum 6.67 percent of its total capital available for one company. While the Committee acknowledges that the purpose of aggregate investment limitations is to mitigate risk for taxpayers and private investors by forcing SBIC companies to diversify their portfolios, the Committee is concerned that present law has resulted in less money for a small business receiving SBIC or NMVC financing and also less management counseling because the SBIC or NMVC company is spread too thin with additional investments.

Notably, the management counseling a small business receives is often as important as SBIC or NMVC financing dollars, as was attested to in the Committee roundtable on June 21, 2007, by Mr. Greg Harmeyer, the founder of Tier One Performance Solutions based in Covington, Kentucky, a company that received NMVC funding. Companies that qualify for NMVC financing by their very nature must be located in a distressed or under-invested area, which means areas that typically do not have networks and experts to counsel a business. Consequently, these firms do not want an NMVC company's money or expertise diluted among too many firms because it is already hard to come by and they spend a lot of time and money to find a firm that is a good fit. In fact, the small businesses argued as strongly in favor of the change as the investors. "From the company's perspective," said Harmeyer, "when you are looking at investors, it is an enormous effort to manage an investor, to find an investor, and to find a relationship that works * * * if you are limited by follow-on investment to say, you are going to have to find somebody else, that is a big drain on the company's resources to be able to manage multiple investors who may have different interests, who have different, competing thoughts of where they want to go with the company. And so I think it is a detriment to the company if the investor is limited. I also would completely agree that the more an investment company is diluted and has too many companies, the less attention they are going to give you in helping you grow your business."[5]

Last, among the SBIC provisions, the bill allows SBIC Participating Securities funds to draw leverage based on SBA-approved commitments rather than paid-in capital. The SBA is phasing out the Participating Securities program, and the last of the funds were licensed in 2004 and will operate through 2014, at a minimum. However, the authority to draw down their leverage expires next year, at the latest by September 30, 2008, and, according to the industry, at the current investment rate, most funds will not be able to use all their leverage. Without access to that capital, many funds will not be able to support the small businesses in their portfolios that require follow-on investments. Allowing the funds to draw the leverage and save their private capital for follow-on investments could mitigate the unintended adverse consequences of shutting down this program abruptly, which would harm small businesses and their investors. The program was authorized in FY2004 to back $4 billion in SBIC Participating Securities, and the Participating Securities funds paid the fees for the commitments. Because the program participants have already paid for these funds through user fees and the government treats the $4 billion that was committed in 2004 to be spent, the Committee considers this provision to be a technical change rather than a modification that would have significant cost. The Committee considers this modification low risk because the SBA could call the private commitments to cover potential losses if they felt the fund was in trouble and the SBA would retain the authority to approve or deny the request to draw leverage from a fund. Furthermore, the exposure for the SBA was low because there are only 29 funds that

[5] Roundtable on "SBA Reauthorization: Small Business Venture Capital Programs" Before S. Comm. on Small Business & Entrepreneurship, 110th Cong. 40, 66 (2007).

would even be eligible to exercise this option, and not all of those would exercise it because they can only do so based on need and if they are in good standing. They could not draw the commitment merely to hold it.

The Small Business Venture Capital Act also makes changes to the New Markets Venture Capital program. In order to expand access to community development venture capital across the country, the bill adds a geographic requirement to the criteria for selecting NMVC applicants. Building on the current provision to seek "nationwide distribution," it directs the SBA, to the extent practicable, to license NMVC companies in one of each of the SBA's 10 regions. The current six funds cover parts of five regions. The program is missing a presence in the Great Lakes, the South Central United States, the Midwest, the Rocky Mountain Region, the Southwest, and the Pacific Northwest. This section strengthens and harmonizes the current statute so that the Administration is not only required to establish the program but also to implement the program. This clarification was necessary because the program was not implemented in a timely or reasonable way, which created hardships for applicant investment groups and unnecessary oversight by the committee. To help stem the disappearance of U.S. manufacturers, this portion of the legislation also makes it a goal for the SBA to license one fund that will focus on investing in small manufacturing firms. At the request of the SBA at the roundtable, the Managers' substitute amendment changed the geographic distribution and small manufacturer requirements to goals.

To address concerns that the SBA does not devote sufficient resources to the oversight and management of the NMVC program, S. 1662 establishes an Office of New Markets Venture Capital. The office would be dedicated to the management of the New Markets Venture Capital program, and the legislation stipulates that the director will be career staff, rather than a political appointee.

One of the most significant legislative modifications to the program addresses a concern, going back to the original enactment of the NMVC program, when many community development venture capitalists and community development venture capitalist experts, such as Dr. Rubin, argued for the program to target not only specific geographies but also populations. They pointed out that, to have the intended impact, it was important to allow New Markets Venture Capital companies to invest in small businesses that are either located in a specific geographical region or employ people who live in the targeted areas and are very poor. While there was some support in Congress for that combination, others were opposed to it and contended that, if the investments were not place-based, the program would not be effective in attracting venture capital to the neighborhoods that need anchors to generate economic development.

However, those concerns have proven unfounded because: (1) there is a requirement in the current NMVC law that requires 80 percent of an NMVC company's investments to be "located" in a low-income area, which provides a protection against abuses; and (2) one of the companion New Markets programs, the successful New Markets Tax Credit program, was enacted with a definition of geographic area that included target populations. As was pointed out in the Committee roundtable by Dr. Rubin, the country's lead-

ing scholar in this field who was in the final stages of assessing the progress of the NMVC companies for the Agency and who helped craft the original program, targeting by geography alone is too limiting to meet the objectives of the program: "The restrictions that currently exist around investing in census tracts are very, very challenging because census tracts are such a blunt instrument. They change dramatically over the course of the years in between censuses, and areas that used to be better off might become poorer, and yet the census tract doesn't reflect that. Census tracts are large, so you can have pockets of concentrated poverty that are not reflected in the overall designation of that tract * * * . So some kind of modification on the targeting is really quite necessary. And I heard this very loudly from all the funds."[6]

Furthermore, if the program is to reach small manufacturers, the definition must be changed, because even most small manufacturers are too big to re-locate. Dr. Rubin pointed out that, as a consequence of current law, the six NMVC companies have made most of their investments in non-manufacturing companies. Last, for practical purposes, there was a need to harmonize the two programs' definitions of "low-income community" so that the programs complemented each other and were easier for investors to use, thereby attracting more investors and leveraging more investment in small businesses in under-invested areas. For these reasons, S. 1662 changes the definition of low-income geographic area in the NMVC program to match the definition of the NMTC program. It is important to note that, while the Committee modified the definition of low-income geographic area, it preserved HUBZones, Empowerment Zones, and Enterprise Communities as eligible investment areas for NMVC funds. There was a drafting error in the bill, as introduced, that inadvertently eliminated HUBZones, Empowerment Zones, and Enterprise Communities as eligible investment areas for NMVC funds. The managers' substitute amendment fixed that error and also clarified that the entire definition in the New Markets Tax Credit, including "targeted populations," applies.

Finally, the bill includes a provision to eliminate the requirement for NMVC companies to raise matching funds from the private sector to access operational assistance grant money from the SBA. Specifically, NMVC companies were required to raise an amount equal to 30 percent of the private capital they had already raised for the NMVC fund, which amounted to a minimum of $1.5 million. This proved virtually impossible, wasting precious time and dollars flying around the country fundraising. Consequently, when Congress adopted a bill by Senator Harkin that established an NMVC program for rural areas at the Department of Agriculture, it eliminated that requirement. This brings the programs in line with each other. This section of the bill also clarifies current law to provide that NMVC companies have two years to raise the matching private capital. Current statute says that they have "up to" two years. In the past, the SBA has interpreted this to mean that it has the discretion to allow NMVC companies up to two years and has set the time limit for raising the private capital at shorter lengths, which the companies found unreasonable and unrealistic.

[6] Roundtable on "SBA Reauthorization: Small Business Venture Capital Programs" Before S. Comm. on Small Business & Entrepreneurship, 110th Cong. 14, 77 (2007) (Transcript of Proceedings).

V. COMMITTEE VOTE

In compliance with rule XXVI(7)(b) of the Standing Rules of the Senate, the following votes were recorded on June 26, 2007.

A motion by Senator Kerry to adopt the managers' substitute amendment, offered by Senator Kerry for himself and Senator Snowe, to S. 1662 was passed by voice vote. The amendment included S. 1663, a bill to reauthorize the New Markets Venture Capital program.

A motion by the Chair to adopt the "Small Business Venture Capital Act of 2007" as amended, to reauthorize the venture capital programs of the Small Business Administration and for other purposes, was approved by a unanimous 19–0 recorded vote with the following Senators voting in the affirmative: Kerry, Levin, Harkin, Lieberman, Landrieu, Cantwell, Bayh, Pryor, Cardin, Tester, Snowe, Bond, Coleman, Vitter, Dole, Thune, Corker, Enzi, and Isakson.

VI. COST ESTIMATE

In compliance with rule XXVI(11)(a)(1) of the Standing Rules of the Senate, the Committee estimates the cost of the legislation will be equal to the amounts discussed in the following letter from the Congressional Budget Office:

OCTOBER 2, 2007.

Hon. JOHN F. KERRY,
Chairman, Committee on Small Business and Entrepreneurship, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for S. 1662, the Small Business Venture Capital Act of 2007.

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

Sincerely,

PETER R. ORSZAG.

Enclosure.

S. 1662—Small Business Venture Capital Act of 2007

Summary: S. 1662 would authorize funding over the 2008–2010 period for the small business investment company (SBIC) programs operated by the Small Business Administration (SBA). The bill also would amend requirements for disbursing funds under commitments made through the participating securities program.

Assuming appropriation of the necessary amounts, CBO estimates that implementing S. 1662 would result in discretionary outlays of $245 million in 2008 and $1.6 billion over the 2008–2012 period. Further, by modifying the participating securities program, CBO estimates that enacting S. 1662 would increase direct spending by $50 million in 2008. CBO estimates that enacting the bill would have no significant effect on revenues.

S. 1662 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

Estimated cost to the Federal Government: The estimated budgetary impact of S. 1662 is shown in the following table. The costs

of this legislation fall within budget function 370 (commerce and housing credit).

	By fiscal year, in millions of dollars—				
	2008	2009	2010	2011	2012
CHANGES IN SPENDING SUBJECT TO APPROPRIATION					
Participating Securities:					
Authorization Level	500	500	500	0	0
Estimated Outlays	225	500	500	275	0
New Markets Venture Capital Program:					
Subsidy Cost:					
Estimated Authorization Level	9	9	9	0	0
Estimated Outlays	4	8	8	4	0
Operational Assistance Grants:					
Authorization Level	6	7	7	0	0
Estimated Outlays	1	2	5	6	3
Administrative Costs:					
Estimated Authorization Level	19	19	19	20	20
Estimated Outlays	15	18	18	19	19
Total Changes:					
Estimated Authorization Level	534	535	535	20	20
Estimated Outlays	245	528	531	304	22
CHANGES IN DIRECT SPENDING					
Estimated Budget Authority	50	0	0	0	0
Estimated Outlays	50	0	0	0	0

Basis of estimate: S. 1662 would authorize funding over fiscal years 2008 through 2010 for several SBA programs authorized by the Small Business Investment Act. The SBA programs that the bill would reauthorize include the participating securities program, the New Markets Venture Capital (NMVC) program, and the debenture program. Each program provides funding to small business investment companies that make venture capital available to small businesses.

The budgetary accounting for SBA's loan guarantee programs is governed by the Federal Credit Reform Act (FCRA) of 1990, which requires an appropriation of subsidy and administrative costs associated with loan guarantees and loan operations. The subsidy cost is the estimated long-term cost to the government of a loan guarantee, calculated on a net-present-value basis, excluding administrative costs. Administrative costs, recorded on a cash basis, include activities related to making, servicing, and liquidating loans as well as overseeing the performance of lenders.

The budgetary impact of the changes S. 1662 would make to small business investment programs is measured in terms of projected subsidy costs. The bill would not specify an authorization level for either the subsidy or administrative costs, if any, that could be incurred as a result of implementing the changes proposed in the bill. CBO has estimated those amounts based on information from SBA regarding the historical demand for and costs of the agency's small business investment programs.

S. 1662 would change the terms that control disbursement of funds previously committed under the participating securities program. The bill would allow SBICs to request funds from SBA without providing a funded commitment from private investors as required under current law. This change in the conditions of existing agreements with SBICs would be treated as a loan modification; under FCRA procedures, the cost of the modification is estimated

on a net-present-value basis and recorded as a change in direct spending in the year the legislation is enacted.

Spending subject to appropriation

For this estimate, CBO assumes that the bill will be enacted in calendar year 2007 and that the necessary amounts will be appropriated for each year.

Participating Securities. The bill would authorize SBA to purchase up to $500 million in participating securities in each of fiscal years 2008 through 2010. Under the participating securities program, SBA would provide funding to privately owned and operated SBICs to make venture capital investments in qualified small businesses. SBICs would be required to share any profits earned on those investments with SBA.

Prior to March 2005, SBA treated the participating securities program as a credit program under FCRA, so costs for the loan guarantees were recorded on a net-present-value basis. SBA no longer treats the participating securities program as a credit program, however, and now considers the program to be an equity investment in the operation of an SBIC. Therefore, rather than calculating the net present value of the cost of the guarantees, the full cost of the authorized loan level would be recognized in the year it is authorized.

Based on historical demand for guarantees under the program and the gap in availability over the past few years, CBO expects that demand for participating securities would be high. Assuming appropriation of the authorized amounts, CBO estimates that implementing this provision would cost $225 million in 2008 and $1.5 billion over the 2008–2012 period.

New Markets Venture Capital Program. S. 1662 would authorize amounts sufficient to cover the subsidy costs for $150 million in debenture guarantees under the NMVC program over fiscal years 2008 through 2010. Under the program, SBA would guarantee debentures issued by companies authorized to invest in small businesses located in low-income areas. Based on information from SBA, CBO expects that the subsidy cost for the NMVC program would be about 17 percent and that demand for guarantees would fall slightly short of the authorized levels. We estimate that this provision would cost $4 million in 2008 and $24 million over the 2008–2012 period, assuming appropriation of the necessary amounts.

NMVC Operational Assistance Grants. The bill also would authorize the appropriation of funds for grants to companies participating in the NMVC program to provide assistance to small businesses that have received venture capital funding. S. 1662 would authorize the appropriation of $20 million over the 2008–2010 period for technical assistance grants. Assuming appropriation of the authorized amount, CBO estimates that those grants would cost $1 million in 2008 and $17 million over the 2008–2012 period.

Debentures. S. 1662 would authorize SBA to guarantee debentures issued by SBICs in the following amounts: $2.25 billion in fiscal year 2008, $2.5 billion in fiscal year 2009, and $2.75 billion in fiscal year 2010. The debenture program currently operates at a zero-subsidy rate; that is, the costs incurred by SBA to provide the guarantees are offset by fees charged to the borrowers. CBO esti-

mates that reauthorizing the debenture program through 2010 would not have a significant effect on spending subject to appropriation.

Administrative Costs. As specified in FCRA, subsidy rates do not reflect the administrative cost to service loan guarantees. Based on the current administrative costs for SBA's loan programs and accounting for the increase in the purchase of participating securities authorized by the bill, CBO estimates that the administrative costs related to the small business investment programs authorized by S. 1662 would be $15 million in 2008 and $89 million over the 2008–2012 period, assuming appropriation of the necessary amounts.

Direct spending

CBO estimates that enacting section 104 would modify the terms of existing loan guarantees that would result in an additional $250 million in SBIC loan guarantees and would increase direct spending by about $50 million in 2008. Under credit reform procedures, the costs of such loan modifications are estimated on a net-present-value basis and recorded as direct spending in the year in which the legislation is enacted.

S. 1662 would authorize SBA to disburse certain funds previously committed to SBICs through the participating securities program under new terms and conditions. The bill would authorize SBICs to request funds from SBA without providing funded commitments of capital from private sources at the time of the request.

Under the participating securities program in 2004, SBA issued $4 billion in commitments to provide venture capital to SBICs. The commitments are limited to a term of five years; at the end of that period, the funds committed under the program expire, and any unused amounts cease to be available to the SBICs. During that initial period, however, an SBIC could draw against the commitment after demonstrating an appropriate business need that has been approved by SBA and commitments of private funding equal to as much as half of the amount to be used. The new terms under which funds may be requested would apply only to commitments made in 2004—the last year SBA offered guarantees under the participating securities program. CBO expects that commitments made in prior years will expire before S. 1662 is enacted.

S. 1662 would allow SBICs to request payment of committed funds without obtaining a paid commitment from private sources. Based on information from SBA, we estimate that an additional $250 million in committed funds would be requested by SBICs and disbursed under this provision.

While SBA began treating the participating securities program as an equity investment in 2005, this budgetary treatment has not been applied retroactively to commitments already in place; therefore, credit reform rules would apply to this transaction. Because enacting this provision would change the cash flows associated with the participating securities program, the funds requested by an SBIC under new terms would be the result of a modification of the terms under which existing participating securities commitments were made.

Based on information provided by SBA, CBO estimates that the subsidy rate for the participating securities program prior to the

modification is about 16 percent; we expect that this subsidy rate would change as a result of the modification. First, the loan guarantees would become riskier because SBA would be guaranteeing the full amount of the SBIC's request. However, this risk would be somewhat mitigated by a higher chance for profits to be realized because private funding would remain available to SBICs for a longer period of time. We assume the higher risk would slightly outweigh the prospect of shared profits returned to SBA and estimate that the subsidy rate for the additional disbursements would be about 20 percent, resulting in an estimated subsidy cost of $50 million for the $250 million guarantee commitment.

Intergovernmental and private-sector impact: S. 1662 contains no intergovernmental or private-sector mandates as defined in UMRA and would impose no costs on state, local, or tribal governments.

Estimate prepared by: Federal Costs: Susan Willie, Impact on State, Local, and Tribal Governments: Elizabeth Cove, Impact on the Private Sector: Jacob Kuipers.

Estimate approved by: Theresa A. Gullo, Deputy Assistant Director for Budget Analysis.

VII. EVALUATION OF REGULATORY IMPACT

In compliance with rule XXVI(11)(b) of the Standing Rules of the Senate, it is the opinion of the Committee that no significant additional regulatory impact will be incurred in carrying out the provisions of this legislation. There will be no additional impact on the personal privacy of companies or individuals who utilize the services provided.

VIII. SECTION-BY-SECTION ANALYSIS

Section 1. Short title

This section specifies the short title of the legislation as the "Small Business Venture Capital Act of 2007."

Section 2. Definitions

This section provides definitions for the legislation.

Section 3. Table of contents

This section provides the table of contents for the legislation.

TITLE 1. THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

Section 101. Reauthorization

This section reauthorizes the SBIC programs through 2010 and establishes the program levels for each SBIC program. The SBIC Debenture program is reauthorized, allowing SBA to back SBIC debenture guarantees at the following levels: $2 billion in FY 2007; $2.25 billion in FY 2008; $2.5 billion in FY 2009; and $2.75 billion in FY 2010. This section reauthorizes the SBIC Participating Securities program for $500 million a year for each of FY 2007 through FY 2010.

Section 102. Leverage

The section simplifies the rules regarding the maximum outstanding leverage allowed for funds: (1) the maximum amount of

outstanding leverage made available to any one SBIC may not exceed $150 million; (2) the maximum amount of outstanding leverage made available to two or more SBICs that are commonly controlled may not exceed $225 million; (3) the $150 million and $225 million are increased to $175 million and $250 million, respectively, for any SBIC that certifies that not less than 50 percent of its investments are made in companies that prior to the investment are owned by either women or minorities, as defined by the SBA Administrator, or are located in a low-income geographic area; and, (4) the Annual CPI adjustments are eliminated.

Section 103. Investments in smaller enterprises

The section requires each SBIC, as a condition of an application for leverage, to certify that not less than 25 percent of the fund's aggregate dollar amount of financings will be provided to "smaller enterprises."

Section 104. Private capital

The section allows Participating Securities SBICs to draw leverage based on SBA-approved commitments rather than paid-in capital. The section clarifies that the provision applies only to Participating Securities SBICs licensed prior to October 1, 2004, not debenture funds.

Section 105. Maximum investment in a company

The section increases from 20 percent to 30 percent the maximum investment allowed in a company, and it applies to the SBIC and the NMVC programs.

TITLE II. NEW MARKETS VENTURE CAPITAL PROGRAM

Section 201. Diversification of New Markets Venture Capital program

This section adds a geographic goal to the criteria for selecting applicants to the New Markets Venture Capital program in order to expand access to community development venture capital across the country. This section strengthens and harmonizes the current statute so that the Administration is not only required to establish the program but to implement the program. To help stem the disappearance of U.S. manufacturers, the section establishes a goal for the SBA, to the extent practicable, to license one fund that will focus on investing in small manufacturing firms.

Section 202. Establishment of Office of New Markets Venture Capital

This section establishes an office dedicated to the management of the New Markets Venture Capital program. It stipulates that the director will be career staff, rather than a political appointee.

Section 203. Low-income geographic areas

This section harmonizes the definition of low-income geographic area of the New Markets Venture Capital program with the definition of low-income community used for the New Markets Tax Credit, which includes targeted populations. And it preserves

HUBZones, Empowerment Zones, and Enterprise Communities as eligible investment areas for NMVC funds.

Section 204. Applications for New Markets Venture Capital program

This section requires the SBA within one year to establish a standard documents required from applicants for final approval.

Section 205. Operational assistance grants

This section changes the law so that firms no longer need to raise $1.5 million in matching funds to access operational grant funding. Instead, they will be able to receive a grant of the lesser of either 10 percent of the private capital they must raise or $1 million. Also under this section, it clarifies that conditionally approved NMVC funds will have a full two years to raise the minimum $5 million in private capital.

Section 206. Authorization

This section reauthorizes the NMVC program for three years, through 2010. The legislation freezes the debenture authorization, allowing the SBA to back $150 million in debentures, and reduces from $30 million to $20 million the authorization for operational assistance grants, assuming a maximum $1 million for each operational assistance grant for a possible high of 20 new funds.

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