

# Rules and Regulations

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This section of the FEDERAL REGISTER contains regulatory documents having general applicability and legal effect, most of which are keyed to and codified in the Code of Federal Regulations, which is published under 50 titles pursuant to 44 U.S.C. 1510.

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## FARM CREDIT ADMINISTRATION

### 12 CFR Parts 611, 612, 619, 620, and 630

RIN 3052-AC41

#### Compensation, Retirement Programs, and Related Benefits; Effective Date

**AGENCY:** Farm Credit Administration.

**ACTION:** Notice of effective date.

**SUMMARY:** The Farm Credit Administration (FCA or Agency), through the FCA Board (Board), issued a final rule amending its regulations for Farm Credit System banks and associations to require disclosure of pension benefit and supplemental retirement plans and a discussion of the link between senior officer compensation and performance. In accordance with the law, the effective date of the final rule is 30 days from the date of publication in the **Federal Register** during which either or both Houses of Congress are in session.

**DATES:** *Effective Date*—Under the authority of 12 U.S.C. 2252, the regulation amending 12 CFR parts 611, 612, 619, 620 and 630 published on October 3, 2012 (77 FR 60582) is effective December 17, 2012.

*Compliance Date*—All provisions of this rule require compliance 30 days after the effective date, except advisory votes on compensation increases under § 611.410(b). Advisory votes on compensation increases of 15 percent or more are not required until 2015, using a baseline year of 2013.

**FOR FURTHER INFORMATION CONTACT:** Deborah Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, Virginia 22102-5090, (703) 883-4498, TTY (703) 883-4434, or Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean,

Virginia 22102-5090, (703) 883-4020, TTY (703) 883-4020.

**SUPPLEMENTARY INFORMATION:** The Farm Credit Administration (FCA or Agency), through the FCA Board (Board), issued a final rule under parts 611, 612, 619, 620 and 630 on October 3, 2012 (77 FR 60582) amending our regulations for Farm Credit System banks and associations to require disclosure of pension benefit and supplemental retirement plans and a discussion of the link between senior officer compensation and performance. In accordance with 12 U.S.C. 2252, the effective date of the final rule is 30 days from the date of publication in the **Federal Register** during which either or both Houses of Congress are in session. Based on the records of the sessions of Congress, the effective date of the regulations is December 17, 2012. (12 U.S.C. 2252(a)(9) and (10))

Dated: December 20, 2012.

**Dale L. Aultman,**

*Secretary, Farm Credit Administration Board.*

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## SMALL BUSINESS ADMINISTRATION

### 13 CFR Part 121

RIN 3245-AG46

#### Small Business Size Regulations, Small Business Innovation Research (SBIR) Program and Small Business Technology Transfer (STTR) Program

**AGENCY:** Small Business Administration.

**ACTION:** Final rule.

**SUMMARY:** The U.S. Small Business Administration (SBA) has amended its regulations governing size and eligibility for the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs. This rule implements provisions of the National Defense Authorization Act for Fiscal Year 2012. The rule addresses ownership, control and affiliation for participants in the SBIR and STTR programs. This includes participants that are majority-owned by multiple venture capital operating companies, private equity firms or hedge funds.

**DATES:** This rule is effective January 28, 2013.

**FOR FURTHER INFORMATION CONTACT:** Carl Jordan, Office of Size Standards, at (202) 205-6618, or Edsel Brown, Assistant Director, Office of Technology, at (202) 205-7343. You may also email questions to [sizestandards@SBA.gov](mailto:sizestandards@SBA.gov).

**SUPPLEMENTARY INFORMATION:**

#### I. Background

On May 15, 2012, at 77 FR 28520 (available at <http://www.gpo.gov/fdsys/pkg/FR-2012-05-15/pdf/2012-11586.pdf>), the U.S. Small Business Administration (SBA or Agency) published a proposed rule to implement provisions in the National Defense Authorization Act for Fiscal Year 2012 (Defense Authorization Act), Public Law 112-81, which affected the SBIR and STTR programs. Specifically, section 5001, Division E of the Defense Authorization Act contained the SBIR/STTR Reauthorization Act of 2011 (SBIR/STTR Reauthorization Act), which set forth several provisions relating to businesses majority-owned by venture capital operating companies (VCOs), hedge funds or private equity firms and provided that such businesses may participate in the SBIR program, under certain conditions.

The SBIR/STTR Reauthorization Act provided a short timeframe for SBA to issue a proposed rule. Therefore, the Agency could not conduct public outreach prior to drafting and issuing the proposed rule. However, in addition to soliciting public comments, SBA conducted several public outreach sessions following publication of the proposed rule, which were coordinated by SBA's Office of Advocacy. 77 FR 30227 (May 22, 2012). SBA held these outreach sessions in Washington, DC; Boston, Massachusetts; Austin, Texas; and New Orleans, Louisiana. In addition, SBA held an online webinar.

SBA received over 250 comments in response to the proposed rule. The comments relating to specific sections of the rule are discussed in further detail below.

#### II. Summary of and Response to Comments

##### A. Section 121.701—Definitions and Programs Subject to Size Determinations

In § 121.701, SBA proposed to make it clear that the size and ownership/control regulations apply to both the SBIR and STTR programs. In addition,

SBA proposed several definitions applicable to the programs, and set forth in statute, to this section.

Specifically, SBA proposed definitions for the terms “VCOC,” “hedge fund,” and “private equity firm.” The proposed definitions are verbatim from the SBIR/STTR Reauthorization Act, which defined those terms. SBA received no comments on these definitions.

SBA had also proposed to define the term “portfolio company” because the SBIR/STTR Reauthorization Act uses that term when referring to VCOCs, hedge funds and private equity firms, but does not define it. SBA proposed to define the term “portfolio company” to mean any company owned by the VCOC, hedge fund or private equity firm. SBA received only one comment on the definition of “portfolio company.” The one comment supported SBA’s definition and agreed that it is simpler and easier to understand than the Department of Labor regulation reviewed by SBA. Therefore, SBA has adopted the proposed definition of the term “portfolio company” as final in this rule.

SBA also proposed a definition for the term “domestic business concern.” That issue is addressed in the next section concerning ownership and control of the SBIR/STTR awardee.

#### *B. Section 121.702—Ownership and Control—General*

In this section, SBA proposed amendments to the ownership and control of SBIR and STTR participants. At the time SBA issued the proposed rule, SBA’s existing regulations stated that an SBIR awardee must be a business concern that is at least 51% owned and controlled by U.S. citizens or permanent resident aliens, or a business concern that is at least 51% owned and controlled by another business that is at least 51% owned and controlled by U.S. citizens or permanent resident aliens. SBA considered retaining this ownership and eligibility criterion since it ensures that there is domestic ownership and control of SBIR and STTR participants. However, SBA believed this criterion was too restrictive and failed to provide sufficient flexibility to small businesses when creating their ownership structure.

As a result, SBA had proposed that an SBIR and STTR awardee must be: (1) More than 50% owned and controlled by U.S. citizens, permanent resident aliens, or domestic business concerns; or (2) majority-owned by multiple domestic VCOCs, hedge funds or private equity firms. As set forth above, SBA’s

then-current rule had already permitted majority ownership by more than just individuals; it also permitted majority ownership by one other business concern. The proposed rule opened the door to permit majority ownership by more than one business concern; in this case, it would have permitted majority ownership by more than one domestic business concern. (SBA also proposed eligibility requirements for those small businesses that are majority-owned by multiple VCOCs, hedge funds or private equity firms. That eligibility criterion is addressed in the next section).

SBA had proposed a definition for the term “domestic business concern” to ensure that entities owning the SBIR or STTR awardee were domestic or U.S. based companies. SBA proposed that a domestic business concern is for profit, has a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor and be created or organized in the United States, or under the law of the United States or of any State. In the preamble to the proposed rule, SBA specifically stated that it considered whether to include a requirement that to be considered a domestic business concern, more than 50% of the business must either directly or indirectly be owned by U.S. citizens, permanent resident aliens, or domestic corporations, partnerships or limited liability companies (LLCs) and requested comments on this issue.

The majority of comments received on this rule concerned the ownership and control requirements proposed and SBA’s proposed definition of the term “domestic business concern.” SBA notes that some respondents agreed with the proposed eligibility criteria while others believed that the definition was too stringent and that SBA should broaden it. These respondents believed that having a United States base for the company and having the money spent here makes the company domestic. They believed that small businesses should see this as an opportunity to recruit more businesses and investments from abroad, as one respondent had already done. One respondent recommended SBA expand the ownership criteria to include ownership by H1 visa holders since many of them are technical people and not including them seems overly restrictive.

Most of the comments SBA received, however, stated that majority ownership of an SBIR or STTR awardee by domestic business concerns, where there is no requirement that such

business concern be majority-owned by U.S. citizens, will allow foreign investors to own and control an SBIR awardee and participate in the program. These respondents thought the proposed rule created a loophole that would allow non-domestic entities to create a domestic company in the United States by merely filing some papers and owning an SBIR or STTR awardee. These respondents expressed concern that this would cause U.S. taxpayer money to be spent overseas (despite the fact there is an SBIR and STTR requirement that the work performed on an SBIR/STTR project be performed in the United States).

Other respondents expressed concern that the proposed rule would create a security risk and permit mission critical and sensitive technologies to be leaked overseas; although, at least one respondent noted that there are current restrictions by the Department of Defense and Federal Acquisition Regulations already in place to prevent this. Some respondents were concerned that the proposed rule could cause an increase in the number of SBIR and STTR solicitations being subject to International Traffic in Arms (ITAR) restrictions. Two respondents wanted SBA to limit foreign ownership to only 25% of an SBIR/STTR awardee; one respondent suggested that an SBIR/STTR awardee can be owned by U.S. companies, but the ownership must be 100%; and another suggested that the SBIR/STTR awardee must be 100% owned by U.S. citizens.

Many of these respondents asked SBA to ensure that awardees remain domestically-owned in order to increase competitiveness in the United States. These respondents requested that SBA focus on the ownership of any entity that owns an SBIR or STTR awardee rather than where that entity incorporates or is located. These respondents believed that having a limitation on foreign ownership of any entity that owns an SBIR or STTR participant will prevent any potential loopholes. Other respondents recommended SBA retain its current rule; although some of these respondents seemed confused and believed that only U.S. citizens, and no business concerns, could currently own the SBIR or STTR awardee.

In reviewing these comments and the concerns expressed by the respondents, SBA has issued a final rule that restricts foreign ownership in SBIR and STTR awardees and has therefore removed as unnecessary the definition of domestic business concern. Specifically, the final rule provides that an SBIR/STTR awardee must be a concern which is

more than 50% directly owned and controlled by one or more individuals who are citizens of the United States or permanent resident aliens in the United States, and/or other business concerns, each of which is more than 50% directly owned and controlled by individuals who are citizens of or permanent resident aliens in the United States. For example, a business that is 40% owned by U.S. citizens and 11% owned by a business concern that is in turn more than 50% owned and controlled by U.S. citizens, would be eligible for the SBIR or STTR program. SBA believes that this regulation addresses the concerns set forth in the comments that SBA should limit foreign ownership of an SBIR/STTR concern and ensure that the SBIR/STTR concern is owned and controlled by U.S. citizens.

SBA also believes that this final rule is very similar to the former eligibility rule for the program, with only one modification. This final rule allows majority ownership by multiple small businesses while the former rule allowed majority ownership by one small business; further, both this final and the former rule require that these businesses be owned and controlled by U.S. citizens or permanent resident aliens.

We also note that as in the proposed rule, SBA retained those provisions concerning ownership of an awardee by an Employee Stock Ownership Plan and eligibility of a joint venture. However, the content has been moved from § 121.702(b) into the new section on SBIR ownership in § 121.702(a) and STTR ownership in § 121.702(b) and in § 121.702(c)(6).

#### *C. Section 121.702—Ownership and Control by VCOCs, Hedge Funds or Private Equity Firms*

The SBIR/STTR Reauthorization Act specifically permits, in certain instances, awardees that are majority-owned by multiple VCOCs, hedge funds or private equity firms to participate in the SBIR program. Therefore, SBA had proposed amending its regulations to address this new statutory requirement.

SBA received several comments stating that it should not permit business concerns that are majority-owned by multiple VCOCs, hedge funds or private equity firms to participate in the SBIR program. Other comments stated that the regulations failed to set forth the statutory limitations on such business concerns—that they receive only a certain percentage of the SBIR set-aside funds.

As noted above, the recent statutory amendments to the SBIR program specifically permit companies that are

majority-owned by multiple VCOCs, hedge funds or private equity firms to participate in the program. Therefore, SBA has issued final regulations permitting such businesses to participate in the SBIR program.

In addition, we note that SBA's regulations do not address the limitations set forth in statute for participation of small businesses that are majority-owned by multiple VCOCs, hedge funds or private equity firms. Specifically, the statute states that the National Institutes of Health, Department of Energy, and the National Science Foundation may award not more than 25% of their SBIR funds to such small businesses. All other SBIR agencies may award not more than 15% of their SBIR funds to these small businesses. Those restrictions are set forth in the SBIR Policy Directive, which was published as final on August 6, 2012 at 77 FR 46806 (available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-06/pdf/2012-18119.pdf>). Because those provisions do not relate to the size or ownership of an SBIR/STTR awardee, they are not part of this regulation and only set forth in the policy directive.

SBA also received several comments stating that businesses that are majority-owned by VCOCs, hedge funds or private equity firms should not participate in the STTR program. When drafting the regulations, SBA considered the fact that the statutory provisions relating to majority ownership by VCOCs, hedge funds or private equity firms specifically apply to the SBIR program. In addition, SBA considered the fact that § 5104 of the SBIR/STTR Reauthorization Act permits a small business concern that received a Phase I award under the SBIR or STTR program to receive a Phase II award in either the SBIR or STTR program. Therefore, an SBIR Phase I awardee may be able to receive an STTR Phase II award. Therefore, SBA believed that the eligibility rules of both programs should be the same and consistent. As a result, SBA's proposed amendments relating to concerns that are majority-owned by multiple VCOCs, hedge funds or private equity firms applied to both the SBIR and STTR programs.

Several respondents argued that concerns that are majority-owned by multiple VCOCs, hedge funds or private equity firms should not be able to participate in the STTR program because it was not so intended by Congress. One respondent believed that money in the STTR program is already going to universities and this proposal would dilute the program more for small businesses. SBA has reviewed this issue and has decided that such

businesses may not participate in the STTR program. SBA has revised the rule accordingly and has set forth two separate eligibility criteria—one for the SBIR program (§ 121.702(a)) and one for the STTR program (§ 121.702(b)).

SBA also received several comments stating that the rule needs to ensure that the VCOC, hedge funds and private equity firms that own an SBIR awardee are more than 50% owned by U.S. citizens and/or not controlled by foreign investors. Many respondents suggested that the VCOC, hedge fund and private equity firm disclose their foreign ownership. SBA has reviewed these comments and has retained the requirement in the rule that the VCOC, hedge fund or private equity firm must have a place of business located in the United States and be created or organized in the United States, or under the laws of the United States or of any State in order to ensure that it is domestically-owned and not foreign-controlled. SBA believes that it would be difficult for small businesses to certify as to the ownership of a VCOC, hedge fund or private equity firm without undue burden.

In addition, a few respondents believed that there were some potential loopholes with the ownership by VCOCs, hedge funds or private equity firms. Specifically, one respondent stated that the same investors could own several VCOCs, which in turn own the SBIR awardee. Although on paper the SBIR awardee would be majority-owned by several VCOCs, in reality it would be owned and controlled by the same group of investors. Another respondent stated that a domestic company could own more than 50% of an SBIR awardee and in turn, that domestic company is owned by a VCOC. In essence, one VCOC could own more than 50% of an SBIR awardee.

SBA does not believe the final rule creates these loopholes. First, any awardee that is majority-owned by VCOCs, hedge funds or private equity firms will be subject to the limitation on awards to such business. We do not believe that investors will set up several VCOCs and have those VCOCs invest in an SBIR awardee simply to skirt the limitations on the awards to small businesses that are majority-owned by VCOCs. Second, under the rules a small business that owns more than 50% of an SBIR awardee could not, in turn, be majority-owned by a VCOC since the rule requires that such business concerns be more than 50% owned by U.S. citizens or permanent resident aliens.

Finally, two respondents believed that one VCOC should be permitted to own

more than 50% of an SBIR awardee. One respondent stated that it is easier to work with one investor than with multiple investors. In response to these comments, we note that the SBIR/STTR Reauthorization Act specifically permits participation in the SBIR program by businesses that are majority-owned by *multiple* VCOCs, hedge funds or private equity firms. As a result, SBA is implementing those provisions and is not permitting majority ownership by a *single* VCOC, hedge fund or private equity firm.

#### D. Section 121.702—Ownership and Control—Fully Diluted Basis

SBA received one comment stating that it should evaluate ownership and control of a company using fully diluted shares on a converted basis. This respondent stated that this is the financial figure companies commonly provide to investors to assess their financial situation. Therefore, it is easy for a company to provide this information. Determining ownership and control on a fully diluted basis means that all of the following would be considered: Outstanding common stock, all outstanding preferred stock (on a converted to common basis), all outstanding warrants (on an as exercised and converted to common basis), all outstanding options and options reserved for future grants, and any other convertible securities on an as converted to common basis. This respondent believes it would accurately reflect ownership and ensure that companies are consistently providing the most transparent information regarding ownership. In addition, the respondent believed that this type of evaluation should also be used to determine affiliation.

SBA agrees with this comment and has added this to the final rule at § 121.702(d). SBA believes that this provision clarifies this issue and utilizes a definition that is most commonly used in the market and is therefore consistent with generally accepted market practice. In addition, SBA's regulations have always given present effect to stock options when calculating an individual's or entity's ownership and control and it is thus logical and consistent to have that be the case when calculating total ownership and control of the business. This will clarify how SBA determines affiliation, ownership and control for the program.

#### E. Section 121.702—Size and Affiliation

##### 1. Size—500 Employee Size Standard

Section 5107(c)(3)(B) of SBIR/STTR Reauthorization Act requires that under

the already existing authority for SBA to establish size standards, 15 U.S.C. 632(a), SBA shall establish size standards for awardees that are majority-owned by multiple VCOCs, hedge funds or private equity firms. The current size standard for SBIR and STTR awardees is 500 employees. This means that an awardee, including its affiliates, cannot have more than 500 individual employees on a full-time, part-time or other basis, and includes employees obtained from a temporary employee agency, professional employer organization, or leasing concern. SBA uses the average number of the business concern's employees based upon the number of employees for each of the pay periods for the preceding completed 12 calendar months (*see* 13 CFR 121.106(b)(1)) to determine the size of the business.

SBA had reviewed the 500-employee size standard and did not propose any changes. The 500 employee size standard is the current size standard for all research and development (R&D) North American Industry Classification System (NAICS) codes, including SBIR and STTR. For example, both NAICS 541711, Research and Development in Biotechnology, and NAICS 541712, Research and Development in the Physical, Engineering and Life Sciences (except Biotechnology) have 500 employee size standards.

Some respondents recommended that SBA retain the current size standard. Other respondents stated that the size standard should be lowered and believed that the size standard should be anywhere from 20 to 300 employees. Most of these respondents believed that any company with more than 100 employees has sufficient capital for their business and does not need to participate in a small business set-aside program. Some respondents thought there should be a dual size standard—a receipts-based and employee-based size standard for SBIR and STTR awards. Two respondents recommended a gross revenue or asset limitation in addition to the employee size standard. Two other respondents recommended SBA define size in categories (very small/small or discovery, early stage, small business growth). Three respondents believed SBA should only count full-time or full-time equivalents as employees and not count individuals working part-time as employees.

SBA notes that in 2007, it began a comprehensive review of its size standards to determine whether existing size standards have supportable bases relative to the current data, and to revise them, where necessary. In addition, on September 27, 2010, the President of the

United States signed the Small Business Jobs Act of 2010 (Jobs Act), Pub L. 111–240, which directs SBA to conduct a detailed review of all size standards and to make appropriate adjustments to reflect market conditions. Specifically, the Jobs Act requires SBA to conduct a detailed review of at least one-third of all size standards during every 18-month period from the date of its enactment and review of all size standards not less frequently than once every 5 years thereafter. SBA has chosen not to review all size standards at one time. Rather, it is reviewing groups of related industries on a Sector by Sector basis. When SBA reviews those size standards relating to R&D, it will also review the SBIR and STTR size standards. Therefore, SBA is retaining the current 500 employee size standard.

##### 2. Affiliation—General (§ 121.702(c)(1))

SBA had proposed to amend its regulations relating to affiliation, solely for purposes of the SBIR and STTR programs. SBA's regulations, at § 121.103, address the principles of affiliation. Generally, affiliation exists when one business controls or has the power to control another or when a third party (or parties) controls or has the power to control both businesses. Control may arise through ownership, management, or other relationships or interactions between the parties. Affiliation is an important issue when determining size because SBA counts the receipts, employees, or other measure of the business, and includes those of all its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit (13 CFR 121.103(a)(6)).

Specifically, section 5107(c)(3)(D) of the SBIR/STTR Reauthorization Act set forth an outline for affiliation with respect to those concerns that are majority-owned by VCOCs, hedge funds, or private equity firms, as well as any other business that the VCOC, hedge fund, or private equity firm has financed. In reviewing these statutory provisions, the purpose of the amendments to the SBIR and STTR programs, the purpose of the SBIR and STTR programs, and the overall goal of simplification and maximization of benefits for small businesses, SBA proposed amendments to the current affiliation rules, solely with respect to these programs. As a result, SBA proposed to address size and affiliation for the SBIR and STTR programs in § 121.702, and not in § 121.103, to avoid any confusion. In the proposed rule, SBA sought comments on its proposal to create bright-line tests for SBIR and STTR participants to apply when

determining eligibility with respect to size and affiliation. In addition, SBA sought specific comments on various sections of the proposed rule relating to affiliation.

SBA received numerous comments on its proposed affiliation regulations. Some respondents thought that SBA should retain its current affiliation rules while others thought that the proposed rules are understandable, prevent undue control and meet legislative intent.

SBA also received several comments on the specific affiliation rules it proposed. As a result of the comments received, SBA believes that some changes to the current and proposed affiliation rules are needed and has addressed each below.

### 3. Affiliation—Minority Ownership Rule (§ 121.702(c)(2))

SBA sought comments on what has come to be known as the “minority ownership rule.” Specifically, in the proposed rule SBA explained that where an SBIR or STTR awardee’s voting stock is widely held or two or more persons hold large blocks of voting stock but no one person owns more than 50% of the stock, then it would deem the board of directors to control the awardee. SBA sought comments on that proposal as well as comments on whether it should: (1) Retain the current affiliation rule with respect to minority stock holdings and if so, whether it should set forth a specific threshold by which it will find control and therefore affiliation (e.g., if a person owns 33% or more of the company) in order to create a bright-line test for awardees; (2) find affiliation if two or three persons or businesses collectively own more than 50% of the awardee, and the same two or three persons or businesses collectively own more than 50% of any other company or entity; or (3) implement a rule setting forth both options (1) and (2) above.

SBA received numerous comments stating that SBA should retain the current version of the minority ownership rule. Most of these respondents were concerned that by removing the minority ownership rule, it would allow a large business to own 49% of an SBIR/STTR awardee, or even two large businesses to own most of the company and still be eligible. These respondents thought that eliminating the rule would create a loophole. Other respondents believed that SBA should not focus on the board of directors controlling the company, but should focus on stock or equity ownership in the company. A few respondents stated that venture capital shareholders that own a minority of the company still

control the company by other means, such as control of the board, unilateral right to force a sale, budgets, officers, acquisitions, etc. Two respondents appear to argue that SBA should have separate affiliation rules for venture-backed companies that have been through complex legal negotiations, and other companies.

SBA also received comments supporting SBA’s creation of a bright line test for determining affiliation. One respondent stated that the proposed rule reflected congressional intent and created clear and precise benchmarks. Another respondent stated that SBA should retain the proposed rule finding affiliation only if the entity owns 50% or more of the awardee as long as SBA retains the other affiliation rules to ensure that the minority shareholder is not really controlling the company.

SBA also received one comment on the alternatives proposed concerning the minority shareholder rule. This respondent thought that the alternatives were overly burdensome and may cause affiliation with companies with different goals and risk but merely with shared investors. The respondent believed that SBA should not affiliate companies if two or three persons own more than 50% of an SBIR/STTR awardee and more than 50% of another business since it is normal for investors to invest in similar companies but have these investments considered individual investments.

SBA understands the concerns expressed by the respondents that do not want SBA to change its regulation on the minority shareholder rule. Under that regulation, if a business concern’s stock is widely held and no single block of stock is large as compared to others, then SBA deems the board of directors and President or Chief Executive Officer to control the business concern, unless they can present evidence showing otherwise. In addition, if two or more persons own, control or have the power to control less than 50% of the concern’s voting stock, but the blocks of stock are equal or approximately equal in size and the aggregate of the holdings is large as compared with other stock holdings, then SBA presumes each person to control the business concern.

SBA believes that retaining the current minority shareholder rule would be contrary to the broader mandate of simplifying and clarifying government regulations. In fact, SBA’s Office of Hearings and Appeals (OHA) has stated that there is nothing that defines these requirements in the minority shareholder rule. For example, OHA has stated that there is nothing that “defines exactly how much larger the single-

largest minority interest must be ‘compared to other outstanding blocks of voting stock’ in order to cause affiliation under 13 CFR 121.103(c)(1).” *Size Appeal of SIGA Technologies, Inc.*, SBA No. SIZ–5201 (2011) (available at <http://www.sba.gov/oha/3393>). As a result, SBA has issued a final rule that takes both views into consideration and slightly amends the current minority shareholder rule to create a test for a small business to use when determining its size.

The final rule states that for determining affiliation based on stock ownership, SBA will find a concern is an affiliate of a person that owns, or has the power to control, more than 50 percent of the company’s voting stock; however, SBA may also find a concern an affiliate of a person that owns, or has the power to control, 40% or more of the voting stock based upon the totality of circumstances. SBA reviewed OHA decisions to determine that there may be affiliation with a minority shareholder holding more than 40% of the equity in a business, but there is less of a likelihood of finding affiliation with a minority shareholder holding less than 40% of the equity. See *Size Appeal of Cytel Software, Inc.*, SBA No. SIZ–4822 (2006) (available at <http://www.sba.gov/oha/3393>) (44.07% of voting stock is large compared to the next block of 24.75%); *Size Appeal of Proceadyne Corp.*, SBA No. SIZ–4354 (1999) (available at <http://www.sba.gov/oha/3393>) (42.1% is large compared to the next block of 18.9%); *Size Appeal of Asphalt Products Corp.*, SBA No. SIZ–2589 (1987) (available at <http://www.sba.gov/oha/3393>) (45% is large compared to the next block of 30%); *Size Appeal of Lebanon Foundry & Machine Company*, SBA No. SIZ–2433 (1986) (available at <http://www.sba.gov/oha/3393>) (45% is large compared to the next block of 30%); and *Size Appeal of U.S. Grounds Maintenance, Inc.*, SBA No. SIZ–4601 (2003) (available at <http://www.sba.gov/oha/3393>) (46.67% is large compared to the next block of 33.33%).

In addition, SBA has also included a separate paragraph in the rule stating that it will find affiliation under the totality of circumstances even if no one single factor for finding affiliation exist at § 121.702(c)(10). That means that SBA could find affiliation with a minority shareholder (including one that owns less than 40% equity in the SBIR/STTR awardee) if the totality of the circumstances so warrant such a finding. Consequently, we believe that the combination of all of these provisions in the final rule simultaneously helps give clearer guidance to small businesses while

providing SBA with the flexibility it needs to find affiliation in those cases where businesses may be trying to game the system, which was one of the primary comments received on the rule.

#### 4. Affiliation—Common Management (§ 121.702(c)(3))

SBA received one comment stating that it needs a more explicit test for finding control based upon common management. Specifically, this respondent believes that the officer, managing member, etc. should also be required to own more than 50% of the board seats of another business or own more than 50% of the business.

SBA does not agree with this comment. There are separate tests for affiliation—one finding affiliation based on ownership of equity in the company and one finding affiliation based on management. The two are sometimes intermixed, but it would not be necessary for a finding of affiliation. If a person is the President of one company and also the President of another company, SBA will continue to find that the two companies are affiliated.

#### 5. Affiliation—Identity of Interest (§ 121.702(c)(4))

According to the proposed rule, SBA may find affiliation if two or more persons have an identity of interest, which includes family members with identical or substantially identical business or economic interests or firms that are economically dependent through contractual or other relationships. An individual or firm may rebut a determination of identity of interest with evidence showing that the interests deemed to be one are in fact separate.

One respondent urged SBA to loosen the “economic dependence” element of the identity of interest affiliation rule based on the unique circumstances of research firms. SBA agrees with the comment that in certain situations, such relationships may not constitute affiliation. That is why the rule specifically allows a small business to rebut any presumption of affiliation based upon an identity of interest. SBA did not include the specific reference to research collaborations in the final rule because each situation is different and SBA may still find affiliation to exist based on research collaborations in combination with other factors.

However, based on this comment, SBA did believe it was important to establish a specific standard by which it may find economic dependence under the identity of interest rule. According to SBA’s OHA, it “has found identity of

interest based on economic dependence when one firm relies upon another for 70% or more of its receipts.” *Size Appeal of Faison Office Prods., LLC*, SBA No. SIZ-4834, at 10 (2007) (available at <http://www.sba.gov/oha/3393>). Therefore, in the final rule SBA has stated that it may find affiliation based upon economic dependence if the SBIR/STTR awardee relies upon another entity for 70% or more of its receipts.

#### 6. Affiliation—Newly Organized Concern Rule (§ 121.702(c)(5))

In the proposed rule, SBA sought input on whether the newly organized concern rule applied to the SBIR/STTR programs, which are research and innovation programs. SBA received a few comments stating that such a rule does not apply to these programs and prevents the creation of spin-off firms. One respondent suggested that SBA should specify a number of years after which a firm would no longer be considered “new” under the rule.

Upon further review, SBA believes that the newly organized concern rule is an important affiliation rule since it is used to prevent a new company from forming and subcontracting all of its work to another company that is other than small or otherwise does not meet the eligibility requirements of the program. As a result, SBA is retaining the rule. However, SBA agrees that the rule could be further defined for the SBIR/STTR programs and therefore SBA has issued a final rule stating that a firm that has been actively operating continuously for more than one year will no longer be considered “new” for purposes of this affiliation rule.

#### 7. Affiliation—Ostensible Subcontractor (§ 121.702(c)(7))

SBA also proposed to find affiliation based upon the ostensible subcontractor rule. Two respondents asked SBA to amend the ostensible subcontracting rule so it would not cause affiliation between SBIR/STTR awardees and a subcontractor performing testing or trials of drugs or other products. These respondents explained that it is too costly for small businesses to perform such tests, especially on humans, and that most companies use Clinical Research Organizations to perform such tests. These respondents did not believe they should be found affiliated with such organizations.

SBA agrees with the comments. Although SBA does not believe it would find an SBIR/STTR awardee affiliated with a company performing product testing under the ostensible subcontracting rule (unless of course testing is the sole purpose of the

funding agreement), we do not believe it is necessary to specifically state so in a rule. There are many other instances where SBA would not find affiliation under the ostensible subcontractor rule and as a result, we cannot enumerate each and every one of them in the final rule.

#### 8. Affiliation—License Agreements (§ 121.702(c)(8))

In the proposed rule, SBA stated that it will consider whether there is a license agreement concerning a product or trademark which is critical to operation of the licensee when determining affiliation. However, the rule explained that a license agreement will not cause the licensor to be affiliated with the licensee if the licensee has the right to profit from its efforts and bears the risk of loss. SBA explained that it may find affiliation through other means, such as common ownership or common management.

Two respondents suggested a provision that would find affiliation where a large company has exclusive rights to the intellectual property that would be developed by the SBIR/STTR awardee. SBA believes its regulation addresses this scenario by allowing SBA to find affiliation where the licensee does not have the right to profit from its efforts. Therefore, SBA does not believe any changes are necessary.

One respondent further sought a definition of “critical to operation” with respect to affiliation based on license agreement. SBA clarifies here that the use of the phrase “critical to operation” was intended to exclude any non-critical licenses from affiliation analysis. The affiliation rule here is an adapted version of the franchise rule that SBA uses in its government contracting and financial assistance programs. SBA does not believe any amendment to the proposed rule is required and would use a common sense approach and consider a license agreement to be critical to operation when it is integral to a participant’s business as a franchise is to a franchisee.

#### F. Section 121.704—When SBA Determines Size and Eligibility

SBA’s proposed regulations for the SBIR and STTR programs stated that size and eligibility would be determined at the time of submission of the funding agreement offer and at the time of award for both Phase I and Phase II awards. SBA had requested comments on this proposal and comments on whether it should retain the current requirement that the small business certify its size and eligibility at the time of award only.

Several respondents agreed with the proposed rule and stated that it was appropriate to require certification at time of offer and award. At least one respondent stated that the company should be an established business at the time it submits its proposal. Two respondents agreed that certifying at time of offer is more straightforward because it provides a date certain. Three respondents believed that SBA should require a certification at time of offer and perhaps at time of award, but not during the lifecycle of the program.

Other respondents argued that SBA should only require a small business to certify at the time of award and not require the business to certify at the time of offer. These respondents believe that there should only be certification at the time of award because: Screening small businesses at time of offer is too restrictive and will decrease the number of applicants; there is too much of a lag time between the offer and award and it would maximize the program to require certification at the time of award only; establishing a business is expensive and this should only be required if the company will receive an award; and having certification at the time of offer would allow non-eligible businesses to write a proposal and establish a front company to submit the proposal and acquire the awardee while they wait for the award. One respondent thought we should require certification 30 days prior to award.

In addition, several respondents argued that they would be unable to meet the principal investigator requirement at the time they submit an offer and, therefore, they should only certify at the time of award. One respondent stated that a person should not have to waste resources trying to comply with the requirements at the time of offer, when they are unsure they will even get an award.

We note that several of these respondents misunderstood the proposal. For example, SBA proposed a certification as to size and eligibility (ownership and control requirements) in the rule. Any certification that the principal investigator will spend a certain percentage of his/her time working for the small business has nothing to do with size and eligibility (ownership and control). Therefore, certifications for size and eligibility at the time of submission of a proposal would not have required anything concerning the principal investigator. In other words, the principal investigator could remain at their other job until award, and then go to work for the small business.

In addition, many respondents believe they do not have to be an established business entity at the time they submit the offer. These businesses should consider the fact that the U.S. Government Accountability Office (GAO) has stated the following: "It is true that a contract cannot be awarded to any entity other than the one which submitted the proposal." *Command Management Services, Inc.*, B-310261, B-310261.2, Dec. 14, 2007, 2008 CPD ¶ 29 (available at <http://www.gao.gov/legal/index.html>). GAO believed that having a different offeror and awardee may not bind any legal entity to the contract obligations or may evidence an unacceptable transfer or assignment of proposals. *Trandes Corporation*, B-271662, Aug. 2, 1996, 96-2 CPD ¶ 57 (available at <http://www.gao.gov/legal/index.html>).

Nonetheless, SBA has decided to retain its current rule and require certification as to size and eligibility (ownership and control) at the time of award only. However, we note that the SBIR and STTR Policy Directives will also require the small business to certify it meets the other program criteria (e.g. performing the required percentage of work, employing the principal investigator) at the time of award and during the lifecycle of the award. Further, there may be other certifications required by the System for Award Management (SAM), the new online system that consolidates the capabilities that used to be found in the Central Contractor Registration and Online Representations and Certifications Application.

SBA also requested comments on how to treat an SBIR/STTR business that becomes other than small or is acquired by or otherwise merged with another entity during an SBIR/STTR award. For example, with respect to small business status for government contracting, the small business is permitted to grow to be other than small during the life of the contract and there is no need for it to re-represent its status on a particular contract or for the government to terminate the contract. There are two exceptions to this general rule: (1) A small business must recertify its status if it has been acquired by or merged with another business concern; or (2) the contract is greater than five years. At those times, the small business must recertify its status and if it is no longer small, the contracting officer cannot count any options exercised or orders issued against the contract as an award to a small business. SBA had requested comments on whether this policy and the procedures should be extended to the SBIR program.

SBA received one comment supporting this proposal. The respondent agreed with recertification if there has been a merger or acquisition or the contract or grant exceeds five years (which is rare for a Phase I or Phase II award). As a result, SBA has decided to adopt this proposal in the final rule. Therefore, if an SBIR or STTR awardee is acquired during performance of an SBIR or STTR funding agreement, it is permitted to continue working on the funding agreement. However, it would be required to recertify its size and ownership and control status and if it is no longer small (no longer meets the size/ownership/control requirements of the program), the agency cannot use SBIR funds for the next option on a funding agreement that is a contract or grant or for continuation of a grant. This would mean the agency could fund the award, but not using SBIR/STTR money. SBA has added this requirement to the final rule at § 121.704(b). This is modeled after the recertification provision in SBA's size standard rules. 13 CFR 121.404(g).

SBA has added this requirement to the final rule at § 121.704.

#### *G. Section 121.705—Certification of Size and Eligibility*

Section 5107 of the SBIR/STTR Reauthorization Act requires that all small business concerns that are majority-owned by multiple VCOCs, hedge funds, or private equity firms and qualified for participation must register with SBA prior to or on the date that it submits an application in response to an SBIR solicitation or announcement. In addition, the new statutory provisions require that such small businesses indicate in any SBIR proposal that they have completed this registration. SBA had proposed to amend this section of the regulations to address these new requirements. SBA requested comments on whether it should maintain a separate registration for purposes of the SBIR and STTR programs only, or should amend its current Dynamic Small Business Search (DSBS) system to use as its registry.

SBA received one comment stating that those small businesses that are majority-owned by VCOCs, hedge funds or private equity firms should register, but the registration should be a self-certification. SBA received another comment stating that SBA should create a new registry because we would be collecting more and different information than collected for DSBS.

SBA agrees with these comments. At this time, SBA is working on creating a database, which would be part of the SBIR/STTR system known as Tech-Net.

This database will serve as a registration portal for SBIR and STTR small businesses. This final rule states that such businesses must self-certify their status. SBA has addressed more specifics about the registry and the registration requirements in its policy directives, which can be found at 77 FR 46806 (SBIR Policy Directive, available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-06/pdf/2012-18119.pdf>) and 77 FR 46855 (STTR Policy Directive, available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-06/pdf/2012-18119.pdf>).

In addition, section 5107(a) of the SBIR/STTR Reauthorization Act states that certain “covered small business concerns” are eligible to receive SBIR awards, without regard to whether the covered small business concern meets the requirements for receiving an award under the SBIR program at the time of award, if an agency took longer than nine months from the date applications were due to issue an award. A covered small business concern is one that was not majority-owned by multiple VCOCs, hedge funds, or private equity firms at the time of submission of a Phase I or Phase II application (and therefore did not register), but that was majority-owned on the date of award.

The proposed regulations addressed this statutory provision concerning covered small business concerns and stated that if a small business concern did not register as majority-owned by multiple VCOCs, hedge funds or private equity firms at the time it submitted its application, it must notify the funding agreement officer if, on the date of award, the concern is more than 50% owned by multiple VCOCs, hedge funds, or private equity firms.

SBA received one comment that supports the rule. SBA also received one comment stating that such covered small businesses should not be allowed to participate in the program since at least one SBIR agency often exceeds the 9 month timeframe for making an award. SBA notes that such business concerns are permitted to participate by statute, and therefore this eligibility requirement is set forth in the final rule. As a result, SBA has adopted its proposed rule on this as final.

#### *H. Section 121.1001(a)(4)—Initiating a Protest or Request for Formal Size Determination*

In § 121.1001(a)(4) of the proposed rule, SBA set forth who may initiate a size protest or request a formal size determination. SBA had proposed amending this section to state that a current offeror and the Associate Administrator, Investment Division may

file a protest. Some of these proposed changes corresponded to the move of SBA’s Office of Innovation to its Investment Division.

SBA received one comment noting that there is a redundancy and possible error in the proposed rule, since it states twice that an offeror can file a size protest. SBA has amended and deleted the redundancy and the final rule now permits any offeror or applicant, the funding agreement officer, or personnel from SBA to file a protest.

#### *I. Section 121.1004—Time Limits that Apply to Size Protests*

In this section, SBA proposed to address when a protest may be filed by an offeror/applicant, the contracting officer/funding agreement officer, or SBA with respect to an SBIR or STTR award. The current regulations state that the contracting officer or SBA may file a protest in anticipation of an award. SBA proposed to amend this regulation to state that SBA or the contracting officer/funding agreement officer may file a protest at any time, as long as it is not premature. This means that SBA would not accept a size protest until the awardee has been selected and notified of the award, which is consistent with current practice for its contracting programs.

SBA received one comment stating that neither SBA nor the funding agreement officer should be allowed to file a protest after award. Another respondent stated that SBA should request payroll records to determine size and should audit the business when it is at 50% of its employment size limit.

SBA disagrees with the comment that a protest should not be filed after award by the SBA or the funding agreement officer. SBA may not find out about an award and the funding agreement officer may not receive credible information about the business until after the award is issued. Therefore, SBA and the funding agreement officer should be permitted to still file a size or eligibility protest if there is credible information that the awardee does not meet the program’s requirement. If SBA or the funding agreement officer did not file such a protest, then the same awardee could continue to receive awards for which they might not be eligible. Therefore, SBA has adopted the proposed rule as final.

Further, SBA does not *per se* audit the SBIR and STTR awardees. Instead, SBA will collect payroll and other information during the course of a size protest.

#### *J. Other*

SBA received several comments that are outside the general scope of this rulemaking. For example, we received comments that SBA should: allow the principal investigator to spend less than 50% of his/her time working for the small business; level the playing field between states with a smaller number of SBIR awardees and those with a higher number of SBIR awardees; amend the award threshold; ban lobbying for SBIR companies; limit the number of Phase I awards and the total lifetime accumulated SBIR funds that can be awarded to a small business; require reviewers to review recent patent filings to determine the List of Topics for a solicitation; use SBIR money to only fund risky innovations; help inexperienced bidders; give priority in awards to innovate start-ups; lower the percentage of work a small business is required to perform for a Phase I award; and address disputes involving Phase III awards. SBA has addressed many of these issues in the SBIR and STTR Policy Directives, which are available at 77 FR 46806 (SBIR Policy Directive) and 77 FR 46855 (STTR Policy Directive).

#### **Compliance With Executive Orders 12866, 12988, 13132, 13563, the Paperwork Reduction Act (44 U.S.C., Chapter 35) and the Regulatory Flexibility Act (5 U.S.C. 601–612)**

##### *Executive Order 12866*

OMB has determined that this rule is a significant regulatory action under Executive Order 12866; however this is not a major rule under the Congressional Review Act (CRA). SBA set forth its Regulatory Impact Analysis in the proposed rule and received five comments on it. We have updated the analysis and addressed the comments below.

##### *Regulatory Impact Analysis*

###### 1. Necessity of Regulation

This regulatory action implements the SBIR/STTR Reauthorization Act. Specifically, it implements section 5107 of the SBIR/STTR Reauthorization Act of 2011, which requires SBA to issue final regulations amending 13 CFR 121.103 (relating to determinations of affiliation applicable to the SBIR program) and 13 CFR 121.702 (relating to ownership and control and size for the SBIR program) within one year of passage of the Reauthorization Act.

SBA has amended its regulation to address affiliation, ownership and control for participants in the SBIR and STTR programs. In addition, the agency amended its regulations to address the

new statutory provisions relating to majority ownership of SBIR awardees by VCOCs, hedge funds or private equity firms.

## 2. Alternative Approaches to Rule

SBA considered numerous alternatives when drafting this regulation, which were set forth in the preamble to the proposed rule. SBA received and considered over 250 comments on the proposed rule. Many of the comments set forth alternatives to SBA's proposed rule, which are discussed in the proposed rule preamble. SBA has adopted some of the recommendations set forth in the comments.

## 3. The Potential Benefits and Costs of This Regulatory Action.

In the proposed rule, SBA stated that one potential benefit of the rule is to increase participation in the SBIR and STTR program by providing more businesses access to these programs. SBA stated that the increase in competition would ultimately increase the quality of proposals and spur innovation.

SBA received four comments on this analysis. Three respondents argued that there is no need to increase competition in the SBIR and STTR programs or that increased competition will result in better proposals. These respondents believe that the programs are already competitive; there is simply not enough money to fund all of the proposals.

Competition is one of the central principles of contracting. It is generally believed that when an agency receives multiple offers, there is an increased likelihood the government can acquire higher quality goods and services at lower prices than it would acquire if it awarded contracts without competition or with less competition. However, we understand the concern that these small businesses have expressed concerning the impact this regulation may have on the programs and the potential increase in the number of applications submitted in response to an SBIR or STTR solicitation. We note that agencies are required to report certain information to SBA, so that SBA can monitor the number of applications submitted and the number of awards issued under the program. This information is available at [www.sbir.gov](http://www.sbir.gov). SBA will continue to review this information and monitor any impact on the program.

SBA also received a comment stating that we should take into account the impact of job losses in the U.S. and the increase in jobs overseas as a result of this rule. SBA does not believe this rule will increase job losses in the U.S. or

result in an increase in jobs overseas and the respondent provided no data or evidence to support the contention.

In the proposed rule, SBA stated that there are a few anticipated costs. The statute requires SBA to maintain a registry of businesses that are majority-owned by multiple VCOCs, hedge funds or private equity firms. SBA will maintain a separate system for its registry and this will result in a cost to SBA. Further, as a result of the anticipated increase in proposals for the SBIR/STTR program, we continue to believe the agencies will have a need for additional staff. In addition, we continue to anticipate there may be an increase in size protests, which will increase SBA's size specialists' current workload.

SBA received one comment on the potential costs. This respondent believes that there will be additional recordkeeping costs and this will reduce funds spent on developing the technology. This respondent recommended that SBA increase only the recordkeeping costs for businesses that are majority-owned by multiple VCOCs, hedge funds or private equity firms. SBA agrees that there are new statutory reporting requirements that may increase costs to SBIR and STTR awardees, although SBA intends to try to defray costs by creating a system that does not require a small business to input the same data more than once. SBA addressed these costs in the Paperwork Reduction Act (PRA) information collection it submitted with the SBIR and STTR Policy Directives.

## Executive Order 13563

The SBIR/STTR Reauthorization Act of 2011 imposes a specific statutory deadline by which SBA must issue a proposed and a final regulation. Specifically, SBA was required to issue a proposed rule by April 29, 2012. Given the time needed to comply with various administrative rulemaking requirements, it was not practicable for SBA to hold public forums prior to issuing a proposed rule, as the executive order recommends, and still be able to meet the April 29th statutory deadline. However, SBA held public forums (e.g., town hall meetings, webinars) once it issued the proposed rule to afford the public an opportunity to participate in the rulemaking process as envisioned by this executive order. SBA had also provided for a 60-day comment period and requested comments on not just the entire rule, but specific parts of the rule where SBA considered several alternatives or options for implementation. SBA received over 250 comments on the rule.

## Executive Order 12988

This action meets applicable standards set forth in Sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or preemptive effect.

## Executive Order 13132

For the purposes of Executive Order 13132, SBA has determined that this final rule will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, SBA has determined that this final rule has no federalism implications warranting preparation of a federal assessment.

## Paperwork Reduction Act, 44 U.S.C., Ch. 35

For purposes of the Paperwork Reduction Act, 44 U.S.C. Chapter 35, SBA has determined that this final rule will impose new reporting or recordkeeping requirements. For example, business concerns that are majority-owned by multiple VCOCs, hedge funds or private equity firms must register their status in a database, as the statute requires. However, because the detailed procedures for meeting this requirement are outlined in the SBIR Policy Directive, and not the rule, SBA submitted the information collection to OMB when the Policy Directives were submitted for review.

## Executive Order 13272

Pursuant to Executive Order 13272 and the Small Business Jobs Act of 2010, Federal agencies issuing final rules are required to discuss and give every appropriate consideration to comments received from the SBA's Office of Advocacy to the proposed rule. The Office of Advocacy submitted a comment letter in response to the proposed rule. In the letter, the Office of Advocacy made three recommendations for SBA to consider when drafting the final rule.

First, the Office of Advocacy asked that SBA give full consideration to reviewing the comments of the stakeholders regarding the time at which a small business concern must self-certify its status. SBA had proposed that a small business self-certify its status at the time it submits its proposal and at the time of award. As discussed above in the preamble, SBA reviewed all the comments submitted and in this final rule has retained the current requirement that all SBIR/STTR

awardees must self-certify their eligibility only at the time of award. Therefore, SBA did not adopt its proposed rule on this issue.

Second, the Office of Advocacy stated that SBA should consider allowing only the prospective offerors, among others, to file a size protest. As discussed in the preamble above, SBA amended § 121.1001(a)(4) to clarify that offerors, SBA, or the funding agreement officer may initiate a size protest or request a formal size determination. SBA's proposed rule had stated that prospective or current offerors could file a size protest. However, it was not clear who or what a prospective offeror would be, but it is clear who an actual offeror is—it is someone that actually submitted an offer or application in response to an SBIR/STTR solicitation.

Third, the Office of Advocacy recommended that SBA give full consideration to the comments of the stakeholders regarding the proposed definition of domestic business concern and its potential impact on the SBIR program. As discussed in detail in the preamble, the majority of comments received on this rule concerned the ownership and control requirements proposed and SBA's proposed definition of the term domestic business concern. In reviewing these comments and the concerns expressed by the respondents, SBA has issued a final rule that restricts foreign ownership in SBIR and STTR awardees and has therefore removed as unnecessary the definition of domestic business concern.

*Regulatory Flexibility Act, 5 U.S.C., 601–612*

SBA has determined that this final rule may have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (RFA), 5 U.S.C. 601, *et seq.* SBA addressed the impact of this final rule in its Initial Regulatory Flexibility Analysis (IRFA), which was part of the proposed rule. SBA received one comment that agreed with SBA's analysis and believed that the rule will be helpful to small biotechnology companies, which typically employ fewer than 50 individuals but together employ over 1.6 million people. SBA also received a comment from the SBA Office of Advocacy. The Office of Advocacy's comments are addressed below.

1. What are the reasons for, and objectives of, this final rule?

This regulatory action implements several sections of the SBIR/STTR Reauthorization Act. These sections of the SBIR/STTR Reauthorization Act

address affiliation, ownership and control of SBIR and STTR program participants.

The objective of the final rule is to implement these statutory changes by further defining terms and expanding on the concepts set forth in the SBIR/STTR Reauthorization Act.

2. What is the legal basis for this final rule?

The legal basis for this final rule is the National Defense Authorization Act for Fiscal Year 2012, Section 5001, Division E (cited as the SBIR/STTR Reauthorization Act of 2011 or Reauthorization Act), Public Law 112–81.

3. What is SBA's description and estimate of the number of small entities to which the final rule will apply?

In FY 2009, for the SBIR program, agencies received 22,444 Phase I proposals and 3,352 Phase II proposals. In FY 2009, for the STTR program, agencies received 2,804 Phase I proposals and 467 Phase II proposals. Some of the proposals submitted were by the same small business. However, using these numbers, SBA estimates that approximately 24,000 businesses could be impacted by this proposed rule. This includes those businesses that are currently not eligible under SBA's existing regulations and will become eligible as a result of implementation of the SBIR/STTR Reauthorization Act. SBA did not receive any comments on the estimated number of businesses that could be impacted by the rule.

4. What are the projected reporting, recordkeeping, Paperwork Reduction Act and other compliance requirements?

The proposed rule provided that businesses will need to represent their size status at the time of initial offer and award. However, based upon the comments received, SBA has issued a final rule stating that businesses will represent their size status at the time of award only. If there is a size protest, the small business will need to ensure it has business records that verify their small business status. These are the same documents that a business would keep in the normal course of its activities (stock certificates, by-laws etc.).

SBA explained in the proposed rule that there is a new reporting requirement for those businesses that are majority-owned by multiple VCOCs, hedge funds or private equity firms. However, SBA addressed that reporting requirement and the database used for the reporting, when it amended the SBIR policy directive (*see* 77 FR 46806

(SBIR Policy Directive), 77 FR 46855 (STTR Policy Directive)).

5. What relevant federal rules may duplicate, overlap, or conflict with this rule?

This does not conflict with current provisions in SBA's SBIR and STTR Policy Directives.

6. What significant alternatives did SBA consider that accomplish the stated objectives and minimize any significant economic impact on small entities?

The alternatives SBA considered were those set forth in the comments received on the proposed rule and discussed in the preamble.

**List of Subjects in 13 CFR Part 121**

Administrative practice and procedure, Government procurement, Government property, Loan programs—business, Small businesses.

For the reasons stated in the preamble, SBA amends 13 CFR part 121 as follows:

**PART 121—SMALL BUSINESS SIZE REGULATIONS**

■ 1. The authority citation for 13 CFR part 121 is revised to read as follows:

**Authority:** 15 U.S.C. 632, 634(b)(6), 638, 662, and 694a(9).

■ 2. Amend § 121.103 as follows:

- a. Add a new paragraph (a)(7); and
- b. Add a new paragraph (b)(8).

**§ 121.103 How does SBA determine affiliation?**

(a) \* \* \*

(7) For SBA's Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs, the bases for affiliation are set forth in § 121.702.

(b) \* \* \*

(8) These exceptions to affiliation and any others set forth in § 121.702 apply for purposes of SBA's SBIR and STTR programs.

\* \* \* \* \*

■ 3. Amend § 121.201 by revising paragraph (b) of footnote 11 at the end of the table "Small Business Size Standards by NAICS Industry," to read as follows:

**§ 121.201 What size standards has SBA identified by North American Industry Classification System codes?**

\* \* \* \* \*

Small Business Size Standards by NAICS Industry

\* \* \* \* \*

Footnotes

\* \* \* \* \*

11. \* \* \*

(b) For purposes of the Small Business Innovation Research (SBIR) and the Small Business Technology Transfer (STTR) Programs only, a different definition has been established by law. See § 121.702 of these regulations.

\* \* \* \* \*

■ 4. Revise the undesignated center heading immediately preceding § 121.701 to read as follows:

Size and Eligibility Requirements for the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) Programs

■ 5. Revise § 121.701 to read as follows:

**§ 121.701 What SBIR and STTR programs are subject to size and eligibility determinations and what definitions are important?**

(a) These sections apply to SBA's SBIR and STTR programs, 15 U.S.C. 638.

(b) *Definitions.*

(1) *Funding agreement officer* means a contracting officer, a grants officer, or a cooperative agreement officer.

(2) *Funding agreement* means any contract, grant or cooperative agreement entered into between any Federal agency and any small business for the purposes of the SBIR or STTR program.

(3) *Hedge fund* has the meaning given that term in section 13(h)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1851(h)(2)). The hedge fund must have a place of business located in the United States and be created or organized in the United States or under the law of the United States or of any State.

(4) *Portfolio company* means any company that is owned in whole or part by a venture capital operating company, hedge fund, or private equity firm.

(5) *Private equity firm* has the meaning given the term "private equity fund" in section 13(h)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1851(h)(2)). The private equity firm must have a place of business located in the United States and be created or organized in the United States or under the law of the United States or of any State.

(6) *Venture capital operating company* means an entity described in § 121.103(b)(5)(i), (v), or (vi). The venture capital operating company must have a place of business located in the United States and be created or organized in the United States or under the law of the United States or of any State.

■ 6. Revise § 121.702 to read as follows:

**§ 121.702 What size and eligibility standards are applicable to the SBIR and STTR programs?**

To be eligible for award of funding agreements in SBA's SBIR and STTR programs, a business concern must meet the requirements below at the time of award of an SBIR or STTR Phase I or Phase II funding agreement:

(a) *Ownership and control for the SBIR program.*

(1) An SBIR awardee must:  
 (i) Be a concern which is more than 50% directly owned and controlled by one or more individuals (who are citizens or permanent resident aliens of the United States), other business concerns (each of which is more than 50% directly owned and controlled by individuals who are citizens or permanent resident aliens of the United States), or any combination of these;

(ii) Be a concern which is more than 50% owned by multiple venture capital operating companies, hedge funds, private equity firms, or any combination of these (for agencies electing to use the authority in 15 U.S.C. 638(dd)(1)); or

(iii) Be a joint venture in which each entity to the joint venture must meet the requirements set forth in paragraph (a)(1)(i) or (a)(1)(ii) of this section. A joint venture that includes one or more concerns that meet the requirements of paragraph (a)(1)(ii) of this section must comply with § 121.705(b) concerning registration and proposal requirements.

(2) No single venture capital operating company, hedge fund, or private equity firm may own more than 50% of the concern.

(3) If an Employee Stock Ownership Plan owns all or part of the concern, each stock trustee and plan member is considered an owner.

(4) If a trust owns all or part of the concern, each trustee and trust beneficiary is considered an owner.

(b) *Ownership and control for the STTR program.*

(1) An STTR awardee must:  
 (i) Be a concern which is more than 50% directly owned and controlled by one or more individuals (who are citizens or permanent resident aliens of the United States), other business concerns (each of which is more than 50% directly owned and controlled by individuals who are citizens or permanent resident aliens of the United States), or any combination of these; or

(ii) Be a joint venture in which each entity to the joint venture must meet the requirements set forth in paragraph (b)(1)(i) of this section.

(2) If an Employee Stock Ownership Plan owns all or part of the concern, each stock trustee and plan member is considered an owner.

(3) If a trust owns all or part of the concern, each trustee and trust beneficiary is considered an owner.

(c) *Size and affiliation.* An SBIR or STTR awardee, together with its affiliates, must not have more than 500 employees. Concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists. For the purposes of the SBIR and STTR programs, the following bases of affiliation apply:

(1) *Affiliation based on ownership.* For determining affiliation based on equity ownership, a concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the concern's voting equity. However, SBA may find a concern an affiliate of an individual, concern, or entity that owns or has the power to control 40% or more of the voting equity based upon the totality of circumstances. If no individual, concern, or entity is found to control, SBA will deem the Board of Directors to be in control of the concern.

(2) *Affiliation arising under stock options, convertible securities, and agreements to merge.* In determining size, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.

(i) Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered "agreements in principle" and are thus not given present effect.

(ii) Options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect.

(iii) An individual, concern or other entity that controls one or more other concerns cannot use options, convertible securities, or agreements to appear to terminate such control before actually doing so. SBA will not give present effect to individuals', concerns' or other entities' ability to divest all or part of their ownership interest in order to avoid a finding of affiliation.

(3) *Affiliation based on common management.* Affiliation arises where the CEO or President of a concern (or other officers, managing members, or partners who control the management of the concern) also controls the management of one or more other concerns. Affiliation also arises where a single individual, concern, or entity that controls the board of directors of one concern also controls the board of directors or management of one or more other concerns.

(4) *Affiliation based on identity of interest.* Affiliation may arise among two or more persons (including any individual, concern or other entity) with an identity of interest. An individual, concern or entity may rebut a determination of identity of interest with evidence showing that the interests deemed to be one are in fact separate.

(i) SBA may presume an identity of interest between family members with identical or substantially identical business or economic interests (such as where the family members operate concerns in the same or similar industry in the same geographic area).

(ii) SBA may presume an identity of interest based upon economic dependence if the SBIR/STTR awardee relies upon another concern or entity for 70% or more of its receipts.

(iii) An SBIR or STTR awardee is not affiliated with a portfolio company of a venture capital operating company, hedge fund, or private equity firm, solely on the basis of one or more shared investors, though affiliation may be found for other reasons.

(5) *Affiliation based on the newly organized concern rule.* Affiliation may arise where former or current officers, directors, principal stockholders, managing members, general partners, or key employees of one concern organize a new concern in the same or related industry or field of operation, and serve as the new concern's officers, directors, principal stockholders, managing members, general partners, or key employees, and the one concern is furnishing or will furnish the new concern with contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities, whether for a fee or otherwise. A concern may rebut such an affiliation determination by demonstrating a clear line of fracture between the two concerns. A "key employee" is an employee who, because of his/her position in the concern, has a critical influence in or substantive control over the operations or management of the concern. A concern will be considered "new" for the purpose of this rule if it

has been actively operating continuously for less than one year.

(6) *Affiliation based on joint ventures.* Concerns submitting an application as a joint venture are affiliated with each other with regard to the application. SBA will apply the joint venture affiliation exception at § 121.103(h)(3)(iii) for two firms approved to be a mentor and protégé under SBA's 8(a) program.

(7) *Affiliation based on the ostensible subcontractor rule.* A concern and its ostensible subcontractor are treated as joint venturers, and therefore affiliates, for size determination purposes. An ostensible subcontractor is a subcontractor or subgrantee that performs primary and vital requirements of a funding agreement (*i.e.*, those requirements associated with the principal purpose of the funding agreement), or a subcontractor or subgrantee upon which the concern is unusually reliant. All aspects of the relationship between the concern and subcontractor are considered, including, but not limited to, the terms of the proposal (such as management, technical responsibilities, and the percentage of subcontracted work) and agreements between the concern and subcontractor or subgrantee (such as bonding assistance or the teaming agreement). To determine whether a subcontractor performs primary and vital requirements of a funding agreement, SBA will consider whether the concern's proposal complies with the performance requirements of the SBIR or STTR program.

(8) *Affiliation based on license agreements.* SBA will consider whether there is a license agreement concerning a product or trademark which is critical to operation of the licensee. The license agreement will not cause the licensor to be affiliated with the licensee if the licensee has the right to profit from its efforts and bears the risk of loss. Affiliation may arise, however, through other means, such as common ownership or common management.

(9) *Exception to affiliation for portfolio companies.* If a venture capital operating company, hedge fund, or private equity firm that is determined to be affiliated with an awardee is a minority investor in the awardee, the awardee is not affiliated with a portfolio company of the venture capital operating company, hedge fund, or private equity firm, unless:

(i) The venture capital operating company, hedge fund, or private equity firm owns a majority of the portfolio company; or

(ii) The venture capital operating company, hedge fund, or private equity

firms holds a majority of the seats of the board of directors of the portfolio company.

(10) *Totality of the circumstances.* In determining whether affiliation exists, SBA may consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation.

(d) *Calculating ownership and control.* SBA will review the small business' equity ownership on a fully diluted basis for purposes of determining ownership, control and affiliation in the SBIR and STTR programs. This means that SBA will consider the total number of shares or equity that would be outstanding if all possible sources of conversion were exercised, including, but not limited to: Outstanding common stock or equity, outstanding preferred stock (on a converted to common basis) or equity, outstanding warrants (on an as exercised and converted to common basis), outstanding options and options reserved for future grants, and any other convertible securities on an as converted to common basis.

■ 7. Revise § 121.704 to read as follows:

**§ 121.704 When does SBA determine the size and eligibility status of a business concern?**

(a) The size and eligibility status of a concern for the purpose of a funding agreement award under the SBIR and STTR programs is determined at the time of award for both Phase I and Phase II SBIR and STTR awards, or on the date of the request for a size determination, if an award is pending.

(b) A concern that qualified as a small business at the time it receives an SBIR or STTR funding agreement is considered a small business throughout the life of that specific funding agreement. Where a concern grows to be other than small, the funding agreement agency may exercise the options on the award that is a contract, grant or cooperative agreement or issue a continuation on a grant or cooperative agreement and still count the award as an award to a small business under the SBIR or STTR program. However, the following exceptions apply:

(1) In the case of a merger or acquisition, the awardee must, within 30 days of the transaction becoming final (or the approved funding agreement novation if a novation is required), recertify its small business size status to the funding agreement agency or inform the funding agreement agency that it is other than small. If the awardee is other than small, the agency can no longer fund the options or issue a continuation pursuant to the funding

agreement, from that point forward, with SBIR or STTR funds. Funding agreement novations for reasons other than a merger or acquisition do not necessarily require re-certification. The funding agreement agency and the awardee must immediately revise all applicable Federal contract and grant databases to reflect the new size status from that point forward.

(2) For the purposes of SBIR and STTR funding agreements with durations of more than five years, a funding agreement officer must request that a business concern re-certify its small business size status no more than 120 days prior to the end of the fifth year of the funding agreement, and no more than 120 days prior to exercising any option or issuing any continuation. If the awardee certifies that it is other than small, the funding agreement agency can no longer fund the options or issue a continuation pursuant to the funding agreement with SBIR or STTR funds. The funding agreement agency and the awardee must immediately revise all applicable Federal contract and grant databases to reflect the new size status from that point forward.

(c) Re-certification does not change the terms and conditions of the funding agreement. The requirements in effect at the time of award remain in effect throughout the life of the funding agreement.

(d) A request for a size re-certification shall include the size standard in effect at the time of re-certification.

■ 8. Revise § 121.705 to read as follows:

**§ 121.705 Must a business concern self-certify its size and eligibility status?**

(a) A business concern must self-certify that it meets the eligibility requirements set forth in § 121.702 for a Phase I or Phase II SBIR or STTR funding agreement.

(b) A business concern that is more than 50% owned by multiple venture capital operating companies, hedge funds, or private equity firms and a joint venture where one or more parties to the joint venture is more than 50% owned by multiple venture capital operating companies, hedge funds, or private equity firms must be registered with SBA as of the date it submits its initial proposal (or other formal response) to a Phase I or Phase II SBIR announcement or solicitation. The concern must indicate in any SBIR proposal or application that it is registered with SBA as majority-owned by multiple venture capital operating companies, hedge funds, or private equity firms.

(c) A small business concern that did not meet the requirements of paragraph (b) of this section at the time of its SBIR

proposal or application must notify the funding agreement officer if, on the date of award, the concern is more than 50% owned by multiple venture capital operating companies, hedge funds, or private equity firms.

(1) The concern is still eligible to receive the award if it becomes majority-owned by multiple venture capital operating companies, hedge funds, or private equity firms after the time it submitted its initial proposal (or other formal response) to a Phase I or Phase II SBIR announcement or solicitation if the agency makes the award on or after the date that is 9 months from the end of the period for submitting applications under the SBIR solicitation.

(2) This small business, known as a covered small business concern, would have to certify that it meets the requirements of the SBIR program set forth in §§ 121.702(a)(1)(ii) or 121.702(a)(1)(iii), and 121.702(a)(2) and 121.702(c) at the time of award of the funding agreement.

(d) A funding agreement officer may accept a concern's self-certification as true for the particular funding agreement involved in the absence of a written protest or other credible information which would cause the funding agreement officer or SBA to question the size or eligibility of the concern.

(e) Procedures for protesting an awardee's self-certification are set forth in §§ 121.1001 through 121.1009. In adjudicating a protest, SBA may address both the size status and eligibility of the SBIR or STTR awardee.

■ 9. Amend § 121.1001 by revising paragraph (a)(4) as follows:

**§ 121.1001 Who may initiate a size protest or request a formal size determination?**

(a) \* \* \*

(4) For SBA's Small Business Innovation Research (SBIR) program and Small Business Technology Transfer (STTR) program, the following entities may protest:

(i) An offeror or applicant for that solicitation;

(ii) The funding agreement officer; and

(iii) The responsible SBA Government Contracting Area Director; the Director, Office of Government Contracting; or the Associate Administrator, Investment Division.

\* \* \* \* \*

■ 10. Amend § 121.1004 by revising paragraph (b) as follows:

**§ 121.1004 What time limits apply to size protests?**

\* \* \* \* \*

(b) *Protests by contracting officers, funding agreement officers or SBA.* The time limitations in paragraph (a) of this section do not apply to contracting officers, funding agreement officers or SBA, and they may file protests before or after awards, except to the extent set forth in paragraph (e) of this section, including for purposes of the SBIR and STTR programs. Notwithstanding paragraph (e), for purposes of the SBIR and STTR programs the funding agreement officer or SBA may file a protest in anticipation of an award.

\* \* \* \* \*

■ 11. Amend § 121.1008 by revising paragraph (a) to read as follows:

**§ 121.1008 What occurs after SBA receives a size protest or request for a formal size determination?**

(a) When SBA receives a size protest, the SBA Area Director for Government Contracting, or designee, will notify the contracting officer, the protested concern, and the protestor that the protest has been received. If the protest pertains to a requirement involving SBA's HUBZone program, the Area Director will also notify the D/HUB of the protest. If the protest pertains to a requirement set aside for WOSBs or EDWOSBs, the Area Director will also notify SBA's Director for Government Contracting of the protest. If the protest pertains to a requirement involving SBA's SBIR or STTR programs, the Area Director will also notify the Associate Administrator, Investment Division. If the protest involves the size status of an SDB concern (see part 124, subpart B of this chapter) the Area Director will notify SBA's Associate Administrator for Business Development. If the protest pertains to a requirement that has been reserved for competition among eligible 8(a) BD program participants, the Area Director will notify the SBA district office servicing the 8(a) concern whose size status has been protested. SBA will provide a copy of the protest to the protested concern together with SBA Form 355, Application for Small Business Size Determination, by certified mail, return receipt requested, or by any overnight delivery service that provides proof of receipt. SBA will ask the protested concern to complete the form and respond to the allegations in the protest.

\* \* \* \* \*

Dated: December 18, 2012

**Karen G. Mills,**  
Administrator.

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