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Congress of the United States

House of Representatives

109th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

April 13, 2005

Mr. Gary M. Jackson
Assistant Administrator for
Size Standards
U.S. Small Business Administration
409 Third Street, S.W.
Washington, DC 20416

Re: RIN 3245-AF22 – Small Business Size Standards; Selected Size Standards Issues

Dear Mr. Jackson:

I am writing to you in my capacity as Ranking Democratic Member of the Committee on Small Business. As you are aware, the Committee has jurisdiction over the programs offered by the U.S. Small Business Administration (SBA). In particular, this letter is in response to an item that was included in the Advance Notice of Proposed Rulemaking (ANPR), dated December 3, 2004 on the subject of "Participation by Businesses Majority-Owned by Venture Capital Companies in the SBIR Program." While I am aware that the comment period has closed for the referenced notice, I ask that you include my comments contained herein for the record.

In the ANPR, the SBA sought public comments on whether to provide an exclusion from affiliation for venture capital companies (VCCs) with respect to size determinations for the purposes of eligibility to participate in the Small Business Innovation Research (SBIR) program. The SBA is considering whether VCCs should be deemed as affiliated with the small businesses in which they invest.

As you are aware, the SBIR program requires that a percentage of an agency's extramural research budget is set-aside for small businesses. Phase I awards consist of a research grant of $100,000 for 12 months. Phase II awards consist of a $750,000 research grant for 24 months. The last phase of the program is the commercialization phase and does not include federal research grant funding.

In the ANPR, SBA is essentially evaluating whether to restrict venture capital for small businesses. This consideration is based on flawed logic and an obvious misunderstanding of the intent of VCCs.

Of all the SBA's programs, small businesses participating in the SBIR program are more likely to be eligible to receive venture capital. Based upon concerns expressed by the SBA, it appears as if the SBA expects that if a VCC has majority ownership of a company participating in the SBIR program, the VCC controls the SBIR company, thereby allowing the transfer of federal SBIR research funds directly to the VCC.

In other programs within the jurisdiction of the SBA, the concept of "ownership" versus "control" is well understood – the two best examples of this are the 8(a) program and Small Disadvantaged Business (SDB) certification. For the SBIR program, the SBA has opted to meld these two separate and distinct evaluations. The SBA's own regulations set forth at 13 CFR 124.106, state that "(c)ontrol is not the same as ownership…" Given this, it is my expectation that in the final rule on this subject, SBA differentiate between ownership and control for the SBIR program, thereby allowing VCC ownership of SBIR participant companies.

If the concern is that VCCs desire to control SBIR companies, this represents a poor understanding of venture capital. It is disturbing to learn that the SBA continues to have a misunderstanding of venture capital even though SBA has programs that attempt to increase the access of small businesses to this important financing mechanism. It would be absurd to assume that VCCs invest in a particular company, and then insist on managing the company, even though the specialty of the VCCs is investment rather than scientific research and development. If the VCCs were to assume control, they would no doubt risk their own investment to the extent that the company's existing management has developed the research to this point.

Moreover, if the SBA limits the extent to which VCCs may invest in SBIR participating businesses, SBA is artificially capping the amount of VCC investment available to the small business. Companies that received venture financing between 1970 and 2003 accounted for 10.1 million jobs and $1.8 trillion in revenue in 2003, representing approximately 9.4 percent of total U.S. jobs and revenues. These companies registered 6.5 percent and 11.6 percent gains in jobs and revenues respectively between 2000 and 2003 while national employment fell 2.3 percent and U.S. company revenues rose 6.5 percent. Venture capital investment is important to both job growth and small business growth. Therefore, any final rule promulgated by the SBA should not limit VCC to SBIR participant firms.

One concern raised in objection to allowing increased VCC investment in businesses participating in the SBIR program, is that VCC investment would create winners and losers, given that a small business with VCC investment would be more likely to move into SBIR Phase II and, ultimately, commercialization. Unfortunately, not every SBIR Phase I participant will reach Phase II or Phase III. Limiting the availability of venture capital financing in order to level the playing field is not a realistic proposal. Eventually, certain businesses will be selected for Phase II and commercialization and others will not. During these latter phases, venture capital investment will be necessary to take the business to the next level. The result will simply be the postponement of VCC participation.

Beyond Phase I of the SBIR program, funding commitments for advanced research are required. Section 9(e)(4)(B)(ii) of the Small Business Act specifically states that in Phase II of the SBIR program, a proposal's commercial potential is evidenced, in part, by "the existence of second phase funding commitments from private sector or non-SBIR funding sources." Thus, additional financing is a selection factor as a company attempts to move its research from Phase I to Phase II of the SBIR program. By eliminating venture capital investment as one of these required funding options, the SBA is creating ambiguity in the statute and, more importantly, reducing the ability of small businesses to finance the commercialization of their SBIR proposals.

As the SBA moves to development of a final rule on this subject, it is expected that the SBA will carefully evaluate alternatives that do not limit the ability of a small business to receive venture capital. Further, it is expected that the SBA will enter into dialogue with the VCC industry to gain a better understanding of the role of VCCs in small business financing. Given the many concerns of the Committee with interpretations being made by the SBA on this issue, the SBA should be cautioned that legislative solutions will be evaluated if the agency continues to view this issue in terms of business size rather than business financing.

If you have any questions about this letter, please contact LeAnn Delaney of the Committee staff at (202) 225-4038.

Sincerely,

NYDIA M. VELAZQUEZ
Ranking Democratic Member