Statement
of
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Committee on Small Business
Subcommittee on Finance and Tax

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Madam Chair and Ranking Member and members of the Subcommittee:

Thank you for the opportunity to appear today to give NASBIC's views on the important issue of "Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses." Before turning to my recommendations, I would like to begin with some background information. First, there are three distinct parts that make up the whole of the SBIC program.

1. **The Debenture program.** The Debenture SBIC program has been in operation since the start of the SBIC program in 1958. It is the only leverage SBIC programs that is active today in terms of new licensees. Its purpose is almost exclusively to provide debt financing (generally subordinated debt) to U.S. small businesses. The program design is simple and effective: Debenture SBICs borrow money periodically by issuing SBA-guaranteed Debentures that bear low interest rates by virtue of SBA's guarantee. The loans augment SBIC private capital by a ratio that virtually never exceeds 2:1. The combination of private and borrowed capital is then available to invest in small businesses at higher rates of return—with SBA setting the maximum rates of interest that can be charged.

   SBICs pay interest on Debenture leverage semiannually, but the principal need not be repaid until the end of the debenture term, generally 10 years. The program is operating at a "zero" subsidy rate with no loss to the government. To the contrary, since 1992 the government has made a profit on the program from fees in the amount of $340 million. There are currently 132 Debenture SBICs managing $6.7 billion in committed capital resources. Debenture SBICs invested $1.3 billion in U.S. small businesses in FY 2007, a new high for the program.

2. **The Participating Security program.** The Participating Security program is the newest of the SBIC programs, but—unfortunately and unnecessarily—it is ramping down out of existence. The program was designed to promote equity investments in small companies. Started in FY 1994, it was the fastest growing of the SBIC programs through FY 2004. At that point the government stopped issuing Participating Security licenses because it was determined by OMB and CBO that Participating Securities are not "debt" securities, a necessity for the program to qualify as a credit subsidy program under the requirements of the Credit Reform Act. As a result of that holding, a dollar-for-dollar appropriation would be required for any new leverage. Given the intent that the SBIC program be a credit subsidy program and the scale of the program ($4.0 billion in leverage committed in FY 2004), a dollar-for-dollar approach is untenable. There are 160 Participating Security SBICs still operating (down from a high of 207 at year-end FY 2004. They invested $1.2 billion in FY 2007, down from a high of $1.6 billion in FY 2005. FY 2008 investments will likely total substantially less than $1.0 billion as more and more funds wind up their affairs.

3. **The unleveraged, bank-owned SBIC program.** Bank-owned SBICs were once a major factor in the SBIC program. Banks originally sought licenses to gain exception to laws that prohibited any bank from owning more than 5% of the equity of a portfolio company unless the bank was a licensed SBIC. However passage of the Gramm-Leach-Bliley Act in 1999 removed that prohibition for bank holding companies and bank-owned SBIC investments in small businesses are now largely insignificant. In FY 2007, bank-owned SBICs made just $123 million in investments, only 4.6% of all SBIC investments for the year. Some banks continue to invest funds in Debenture SBICs—generally for CRA credit—but the era of big bank-owned and operated SBICs appears to be over.

With that background, I will now turn to my recommendations.

1. **Improve the Debenture SBIC program.** The House Small Business Committee has already taken the lead in this area by securing passage by the full House of H.R. 3567, the "Small Business Investment Expansion Act of 2007." The bill contains two provisions that are particularly important to both greater growth in the program and greater potential for an individual SBIC to help a small business in which it has made an investment. Section 101 would substantially increase the amount of SBA-guaranteed leverage available to individual SBICs that can raise greater amounts of private capital—thus substantially increasing the amount of capital that would be available for investment in small business. Section 105 of the bill and would increase the amount of capital a single SBIC could invest in a single small business, thus increasing the ability of an SBIC to help its portfolio companies meet their growth plans. Both provisions would make the program more attractive to private investors and to private management teams, thus leading to greater growth in the program. Neither provision has been opposed by the Administration. Unfortunately, the counterpart Senate bill (S. 1662) is bogged down because of a "hold" place on the bill by a single conservative Senator opposed to the SBIC program as a whole. We hope that can be remedied prior to the adjournment of this Congress.

2. **Revive the Participating Security Program or Create an Alternative Equity Focused Program.** Warren Buffett, Chairman and CEO of Berkshire Hathaway Inc., has said: "by any commonsense definition, we are in a recession." That fact will make the availability of equity capital even more important to America's small businesses. Equity capital is the foundation upon which any company is built. A company's ability to raise senior debt and lines of credit—absolutely essential to business success—relates directly to its ability to raise equity capital. The Participating Security has been a great success in that regard:

   - Participating Security (PS) SBICs have made approximately $14 billion in equity investments in U.S. small businesses since the program's inception in FY'94.

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

   - Approximately 35% of all PS investments have been made in manufacturing companies.

   - Equity capital in the SBIC target investment range of $500,000 to $5.0 million is considered the most difficult to secure. PriceWaterhouseCoopers reported that there were $9.5 billion in investments in that range made in the years 2003 through 2005. PS SBICs investments were $4.1 billion (43%) of the equity capital for that period.

   - The $14 billion in PS investments since 1994 have led to the creation of an estimated 385,000 new jobs and $65 billion revenue within the U.S. small businesses that received Participating Security SBIC financing. (These estimates are based on a 2001 National Venture Capital Association study that found that one sustainable job is created for every $36,000 in venture capital invested in a small business and that every $1.00 in venture capital leads to $4.75 in a portfolio company's revenue.)

Unfortunately, the PS program lays moribund, a victim of a 2004 OMB and CBO decision that the SBA-guaranteed "Participating Securities" issued by PS SBICs to raise capital to augment their private capital do not qualify as "debt" securities eligible for appropriations subsidy scoring under the requirements of the Federal Credit Reform Act of 1990. The CBO decision, 10 years after the program had been in operation as a subsidized program (that carried a "zero" subsidy rate for many years), meant that dollar-for-dollar appropriations would be required to continue in the program's existence. The decision has destroyed the PS program.

The destruction of the PS program is not necessary. The 2004 OMB / CBO holding was wrong and should be corrected. Once the OMB / CBO holding is reversed through legislation, the PS program (or a successor program) will again be a subsidized program and appropriate changes can be made in the enabling legislation to reduce the subsidy rate to either "zero" or a positive rate acceptable to Congress. Perhaps the easiest change, and the one with the greatest impact on the subsidy rate, would be to limit the leverage-to-equity ratio of any equity focused SBIC program to 1:1—a 50% reduction in the 2:1 limit allowed pursuant to the current PS legislation.

Analysis of CBO's Erroneous Decision: The Definition of "Debt." The Federal Credit Reform Act of 1990 does not define the term "debt." Absent a definition within the statute itself statutory terms are subject to the "Plain Meaning" rule of statutory construction. See Supreme Court case Caminetti v. U.S., 242 U.S. 470 (1917). According to the plain meaning rule, absent a contrary definition within a statute, words must be given their ordinary meaning. If the words are clear, they must be applied.

The term "debt" is defined in many ordinary contexts.

"A duty or obligation to pay money under an express or implied agreement." Merriam-Webster On-Line Dictionary.

"General name for money, notes, bonds, good, or services which represent amounts owed." New York State Society of Certified Public Accountants.

"The term debt means liability on a claim." Federal Bankruptcy Law, 11 U.S.C. 101(12).

By reference to these definitions, all supported by the "Plain Meaning" rule of statutory construction, both generally accepted accounting principles (GAAP) and SBA-promulgated SBIC regulations require that Participating Securities be characterized as debts on the financial statements of all PS SBICs. It is only CBO and OMB that erroneously disagree with the characterization of Participating Securities as debt for accounting purposes.

Analysis of Relevant Sections of the Participating Security Program Enabling Legislation. The Small Business Investment Act does not define the term debt. However, it is clear from the wording of three provisions of §303 that Congress intended Participating Securities to be a debts.

- "Participating securities shall be redeemed [repaid] not later than 15 years after their date of issuance for an amount equal to 100 per centum of the original issue price plus [contingent interest if any is due under the formula provided]." §303(g)(1).

The above section creates an unambiguous obligation to pay money on the claim created by a participating security.

- "The only debt other than leverage [the amount of money raised by issuance of SBIC participating securities or debentures] obtained in accordance with this title which any company issuing a participating security under this subsection may have outstanding shall be temporary debt …." §303(g)(5).

The phrase "only debt other than leverage" is unambiguous. Congress considered both participating securities and debentures (the only securities that can be used to raise "leverage") to be debts. The term "leverage" is defined by the American Heritage Dictionary to mean "credit or borrowed funds used to improve one's speculative capacity …," i.e., a debt.

- "All fees, interest, and profits received and retained by the Administration under this section shall be included in the calculations made by the director of OMB to offset the cost (as the term is defined in section 502 of the Federal Credit Reform Act of 1990) to the Administration of purchasing and guaranteeing debentures and participating securities under this Act." §303(j).

This section makes clear the congressional intent that the securities issued under the program would qualify for subsidy scoring pursuant to the requirements of the Federal Credit Reform Act. Only if qualified could the receipts be used to offset the costs. The section is an explicit directive that the securities and the receipts realized by the Administration from them are qualified under the Federal Credit Reform Act. Since the Federal Credit Reform Act was passed eight years prior to the legislation creating the PS program, it must be assumed that Congress knew the law. If it had not intended participating securities to be debts for the purposes of the Federal Credit Reform Act it would not have made the receipts deductible from costs in §303(j). OMB and CBO should have given deference to this clear congressional intent.

Legislation Required To Revive The PS Program or Create a New Equity Program. To revive the PS program all that would be required is to amend the last sentence of §303(g) of the Small Business Investment Act—the section that creates participating securities—to read as follows, the new text appearing in italics:

"Participating securities guaranteed under this subsection *shall be considered debt securities for all purposes related to the Federal Credit Reform Act of 1990 and* shall be subject to the following restrictions and limitations, in addition to such other restrictions and limitations as the Administration may determine:"

Amending the SBIA as suggested would correct the erroneous OMB / CBO holding and again make the Participating Security program an effective partner in providing scarce equity capital to U.S. small businesses. As indicated above, an additional amendment to reduce the leverage to equity ratio from 2:1 to 1:1 would likely again reduce the subsidy rate to zero.

An alternative to the above would to create a new "Participating Debenture" program by enacting legislation such as that proposed by NASBIC in 2005.

Thank you again for the opportunity to appear today to address the issue of improving the ability of America's small business to access capital through SBA programs. It is an issue that is critical to economic growth in our country.

Lee W. Mercer

Lee Mercer is president of the National Association of Small Business Investment Companies and has served in that capacity since 1996. Before joining NASBIC he had held positions in both the private and public sectors. He had been a partner in a New Hampshire law firm, a government program manager for Digital Equipment Corporation, and president of two small, privately owned companies. In government he had served as legislative director and counsel for former U.S. Senator Warren Rudman (R-NH) and as a deputy undersecretary of commerce at the Department of Commerce during parts of both the Ronald Reagan and George H. W. Bush administrations. While with Senator Rudman, Lee was the primary manager of the 1982 legislation that created the Small Business Innovation Research (SBIR) program. Lee received his BA degree from Dartmouth College and his JD and LLM degrees from the Boston University School of Law.