



# *SBIC TechNotes*

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## **GUIDELINES CONCERNING DEBENTURE APPLICANTS STRUCTURED AS A BUSINESS DEVELOPMENT COMPANY OR BDC SUBSIDIARY**

The guidance below was developed by the Investment Division of the US Small Business Administration (“SBA”) for applicants and service providers regarding the requirements for issuance of debenture licenses to publicly-held investment companies that have elected to be regulated as a business development company (“BDC”) under the Investment Company Act of 1940. The SBA recognizes the important role played by the BDC community to meet the capital needs of small businesses nationwide, and has historically been willing to support new SBICs that are part of a BDC. This guidance does not represent a change in policy or procedure, but is intended to provide potential applicants with information on SBA’s long-standing practices, based on regulation and precedent, and enable BDC applicants to evaluate their potential fit with the program.

All SBIC applicants interested in pursuing a leveraged debenture securities license must meet the minimum requirements for management teams detailed at [http://www.sba.gov/aboutsba/sbaprograms/inv/forsbicapp/INV\\_APPLICATION\\_PROCESS.html](http://www.sba.gov/aboutsba/sbaprograms/inv/forsbicapp/INV_APPLICATION_PROCESS.html). For BDC applicants, SBA will consider the following additional factors:

1. For purposes of determining the applicant’s Regulatory Capital, 13 CFR §107.50 specifically provides for the exclusion of unfunded capital commitments if “SBA determines that the collectibility of the commitment is questionable”. For example, SBA might determine that collection is questionable for an investor whose net worth is largely tied up in illiquid assets, or whose commitment is contingent upon certain conditions being met in the future. Historically, SBA has demanded a very high level of assurance as to collectibility to allow an unfunded commitment to be counted as Regulatory Capital. For nearly all SBICs that are structured as subsidiaries of a parent entity (“drop-down SBICs”), SBA requires the parent’s capital

commitment to the SBIC to be backed up by “Class B” commitments from the parent fund’s investors. Only in rare cases has SBA determined that Class B commitments are not required. When the parent entity is a BDC, it has no unfunded capital commitments, and obtaining Class B commitments for an SBIC subsidiary is therefore not an option. Therefore:

- a. SBA will generally count a parent BDC’s unfunded capital commitment as Regulatory Capital if (1) the parent’s funded net worth is at least ten times its total capital commitment to the SBIC, and (2) SBA is comfortable that sufficient liquidity exists to fund the commitment, taking into account such factors as cash on hand, access to additional equity capital and non-SBA credit facilities, operating income and expenses, historical and expected portfolio cash projections, and current and long term liabilities. Once SBA has approved a leverage commitment for the SBIC, the company will be permitted to draw the funds in accordance with existing regulations and SBA’s standard credit policies.
  - b. If a parent BDC has (1) funded net worth at least six times its total capital commitment to the SBIC, and (2) SBA is comfortable that sufficient liquidity exists to fund the commitment, SBA will consider the SBIC eligible to obtain a leverage commitment up to two times its Regulatory Capital, but the SBIC’s leverage draw downs will initially be limited to a single tier and a 1:1 leverage ratio until Regulatory Capital is fully paid-in. For example, if the SBIC has \$50 million of Regulatory Capital, it can obtain a \$100 million leverage commitment from SBA, but may only draw one dollar of leverage for every dollar of Leverageable Capital. The SBIC would call capital in this manner until such time as the full \$50 million of Regulatory Capital is fully invested in qualified small businesses or used to pay permissible fund expenses. The second \$50 million of leverage would become available only after the Regulatory Capital is fully paid-in.
  - c. If a parent BDC has funded net worth less than six times its total capital commitment to the SBIC and/or if the Investment Division determines that liquidity is insufficient, its commitment will only be counted as Regulatory Capital to the extent that it is paid-in.
2. The SBIC program is not set up to increase leverage commitments incrementally over time as new Regulatory Capital becomes available to a licensee. SBA allows SBICs to apply for leverage commitments a maximum of two times per calendar year.

3. 13CFR §107.740 requires that no financing or commitment to a small business may exceed 20% of a SBIC's regulatory capital without prior written approval. (Note that recent legislative changes, pending final regulatory implementation, will liberalize the requirement somewhat.) This regulation exists to ensure that SBIC portfolios are well diversified. In determining whether or not a SBIC license is a good fit for their business, BDC applicants should carefully consider the appropriate Regulatory Capital amount in light of their investment strategy and typical investment size.
4. SBA generally prefers SBICs that have a planned 10-15 year lifespan, rather than an evergreen or indefinite life structure.
5. As a general rule, SBA will only license funds that satisfactorily link, either directly or indirectly, incentive compensation of the principals responsible for the SBIC portfolio to the performance of the SBIC.