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SMALL BUSINESS INVESTMENT IMPROVEMENT ACT OF 1999

MARCH 2, 1999.—Ordered to be printed

Mr. BOND, from the Committee on Small Business,
submitted the following

REPORT

[To accompany S. 364]

The Committee on Small Business reported S. 364 to improve certain loan programs of the Small Business Administration, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

I. INTRODUCTION

Last year, the Committee on Small Business approved by an 18-0 vote the “Year 2000 Readiness and Small Business Programs Restructuring and Reform Act of 1998” (H.R. 3412), which was subsequently approved under unanimous consent by the Senate. This omnibus bill included a section on the Small Business Investment Company (SBIC) program that is similar to S. 364. Unfortunately, the House of Representatives was not able to act on the bill prior to the adjournment of Congress in 1998. On February 5, 1999, the Committee voted by unanimous consent to report S. 364 favorably.

In 1958, Congress created the SBIC program to assist small business owners obtain investment capital. Forty-one years later, small businesses continue to experience difficulty in obtaining investment capital from banks and traditional investment sources. Although investment capital is readily available to large businesses from traditional Wall Street investment firms, small businesses seeking investments in the range of \$500,000–\$2.5 million have to look elsewhere. SBICs frequently are the only sources of investment capital for growing small businesses.

In 1992 and 1996, the Committee on Small Business worked closely with the Small Business Administration (SBA) to correct

earlier deficiencies in the Small Business Investment Act of 1958 in order to ensure the future of the program. In 1992, and again in 1996, Congress enacted major changes to strengthen and reform the SBIC program. Today, the SBIC program is expanding rapidly in an effort to meet the growing demands of small business owners for debt and equity investment capital. More qualified investment teams are seeking license approval from SBA than ever before. At the same time the SBIC program is experiencing significant growth, the investment groups that are receiving guaranteed funds for investing in small businesses are performing at an exceptionally high level. The credit subsidy rates for both the Debenture and Participating Securities programs have dropped dramatically, with the subsidy rate for the Debenture program reaching "0" for the first time in the program's history, effective FY 2000.

II. DESCRIPTION OF BILL

In response to the exceptional growth of the SBIC program fostered by the ever-increasing demand from growing small businesses for investment capital, S. 364 would increase the program authorization level for the Participating Securities program. This part of the SBIC program provides SBA-guaranteed capital that is matched with private capital raised by SBICs to make patient investments in small businesses. SBA permits an SBIC to defer payment of interest on Participating Securities until its investment portfolio begins to generate a return on investment sufficient to make the SBIC profitable. In return, SBA receives not only the repayment of principal and interest, but it also can receive up to 12% of the profits earned by the SBIC on each of its portfolio investments.

For Fiscal Year 1999, S. 364 would increase the authorization level of the Participating Securities program from \$800 million to \$1.2 billion. In FY 2000, the authorization level would increase from \$900 million to \$1.5 billion. These higher authorization levels are critical if the SBIC program is going to meet the demand for investment capital from the small business community.

The bill would permit a seemingly small change in the program that will actually have a much more significant impact on the smaller, small businesses that are seeking investment capital. S. 364 would allow an SBIC to accept royalty payments contingent on future performance from a company in which it invests as a form of equity return for its investment. The royalty payments generally would be based on the increase in revenues that accrue after the investment is made by the SBIC.

S. 364 would clarify the rules for determining eligibility of a small business or smaller enterprise that is not required to pay Federal income tax at the corporate level, but that is required to pass income through to its shareholders or partners by using a specified formula to compute its after-tax income. In order for a small business to qualify for a debt or equity investment under the SBIC program, a determination is made as to the entity's net income after Federal taxes are paid. To qualify under the SBIC program, an entity's net yearly income after Federal taxes cannot exceed \$6 million.

The provision in S. 364 would permit these tax “pass through” enterprises to be treated the same as enterprises that pay Federal taxes for purposes of SBA size standard determinations. A “pass through” enterprise would be able to estimate its net income after Federal taxes as if it paid Federal taxes directly to the IRS in order to determine if it falls under the SBA net income threshold.

The “Small Business Investment Improvement Act of 1999” would make two technical changes to the SBIC program. The first technical change would remove a requirement that at least 50% of the annual authorized and funded program level under the Participating Securities program be reserved for funding SBICs that have private capital of not more than \$20 million. This requirement had been imposed to insure that smaller SBICs had ample opportunity each year to obtain SBA-guaranteed leverage without facing the threat that larger SBICs would obtain commitments for all the leverage for the year.

The 50% reserve requirement has become obsolete for three reasons. First, the reserve is not needed because virtually all SBICs have less than \$20 million in private capital. Second, SBA now provides commitments to any SBIC, regardless of size, so long as it is in good standing under the rules of the SBIC program, and it has sufficient available private capital to match with the SBA-guaranteed capital. Third, in 1996 Congress approved a new law that gave the SBA Administrator new authority to make five year leverage commitments for SBICs (Section 211, Public Law 105-135).

As the result of the last two actions, any SBIC may apply for a commitment up to five years which is matched with its private capital, thus negating the need for the 50% reserve rule.

The second technical change in S. 364 requires SBA to issue SBIC guarantees and trust certificates at periodic intervals of not less than twelve months. The current requirement is not less than every six months. This change will give maximum flexibility for SBA and the SBIC industry to negotiate the placement of certificates that fund leverage for the SBICs and obtain the lowest possible interest rates.

This change will not hinder the availability of SBA-guaranteed leverage for SBICs with five-year commitments from SBA to invest in small businesses because the SBIC industry has arranged a bridge funding arrangement with the Federal Home Loan Bank of Chicago. This funding arrangement allows SBICs with commitments from SBA to borrow funds against the SBA commitments. The borrowed funds are repaid to the Federal Home Loan Bank by the SBIC after the SBA-guaranteed leverage funds are distributed

III. COMMITTEE VOTE

In compliance with rule XXVI(7)(b) of the Standing Rules of the Senate, the following vote was recorded on February 5, 1999.

After a quorum was established pursuant to Committee rules, a motion by Senator Bond to adopt the “Small Business Investment Improvement Act of 1999” was approved by unanimous consent.

IV. EVALUATION OF REGULATORY IMPACT

In compliance with rule XXVI(11)(b) of the Standing Rules of the Senate, it is the opinion of the committee that no significant addi-

tional regulatory impact will be incurred in carrying out the provisions of this legislation. There will be no additional impact on the personal privacy of companies or individuals who utilize the services provided.

V. CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirement of section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate. –

VI. COST ESTIMATE

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

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, February 9, 1999.

Hon. CHRISTOPHER S. BOND,
Chairman, Committee on Small Business,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for S. 364, the Small Business Investment Improvement Act of 1999.

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

Sincerely,

DAN L. CRIPPEN, *Director.*

Enclosure.

S. 364—Small Business Investment Improvement Act of 1999

Summary: S. 364 would make a number of technical corrections to the Small Business Investment Act of 1958. It would eliminate a provision in current law that reserves funds for smaller Small Business Investment Companies (SBICs) until the last quarter of the fiscal year. The bill also would allow a more accurate determination of eligibility of small businesses for SBIC programs by requiring the Small Business Administration (SBA) to measure a firm's revenues assuming that it has paid all required income taxes. (Certain corporate structures, such as "S" corporations, pass all income through to the stockholders. Other firms do not pass through income, but instead pay taxes at the corporate level). Finally, S. 364 would give SBA more flexibility in issuing certificates that help finance SBIC activities by increasing the minimum placement period for public offerings from 6 months to 12 months.

The bill would increase the authorized level of loans guaranteed by the SBIC participating securities program in 1999 and 2000. CBO estimates that the subsidy costs of loan guarantees would increase by about \$20 million over the 1999–2004 period.

S. 364 would not affect direct spending or receipts; therefore, pay-as-you-go procedures do not apply. S 364 contains no intergovernmental or private-sector mandates as defined in the Unfunded

Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

Estimated cost to the Federal Government: For purposes of this estimate, CBO assumes that the bill will be enacted by March 31, 1999. CBO further assumes appropriation of the amounts necessary to fund the authorized program levels, including a supplemental appropriation for increases of authorized guarantees amounts in fiscal year 1999. The estimated budgetary impact of S. 364 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By fiscal years, in millions of dollars—					
	1999	2000	2001	2002	2003	2004
CHANGES IN SPENDING SUBJECT TO APPROPRIATIONS						
SBIC Participating Securities Loans ¹ :						
Estimated authorization level	9	11	0	0	0	0
Estimated outlays	3	13	3	(²)	0	0

¹ Implementing S. 364 also would increase SBA's costs for administering guarantees of SBIC securities, but CBO estimates that the changes in administrative expenses would be less than \$500,000 a year.

² Less than \$500,000.

The Federal Credit Reform Act of 1990 requires appropriation of the subsidy costs and administrative costs for credit programs. The subsidy cost is the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present-value basis and excluding administrative costs.

S. 364 would increase the authorized level of loans guaranteed by the SBIC participating securities program from \$800 million to \$1.2 billion in 1999 and from \$900 million to \$1.5 billion in 2000. Based on information from the SBA and on historical data for this program, CBO estimates that the subsidy costs of loan guarantees would increase by \$20 million over the 1999–2004 period. CBO estimates that this provision would not significantly increase the administrative costs of the agency.

Pay-as-you-go considerations: None.

Intergovernmental and private-sector impact: S. 364 contains no intergovernmental or private-sector mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.—

Previous CBO estimate: On January 13, 1999, CBO transmitted an estimate of H.R. 68, the Small Business Investment Company Technical Corrections Act of 1999, a similar bill that was ordered reported by the House Committee on Small Business on January 7, 1999. H.R. 68 would increase the authorized level of loans guaranteed by the SBIC participating securities program from \$800 million to \$1 billion in 1999 and from \$900 million to \$1.2 billion in 2000. The higher costs estimated for S. 364 reflect the higher loan levels that it would authorize: \$1.2 billion in 1999 and \$1.5 billion in 2000.

Estimate prepared by: Mark Hadley.

Estimate approved by: Paul N. Van de Water, Assistant Director for Budget Analysis.

VII. SECTION-BY-SECTION ANALYSIS

Section 1. Short title

This section entitles the legislation the “Small Business Investment Improvement Act of 1999.”

Section 2. SBIC Program

This section consists of five changes to the Small Business Investment Act of 1958 and the Small Business Act.

Subsection (a) would permit a Small Business Investment Company (SBIC) to receive royalty payments contingent on the future performance from small businesses in which it invests as a form of equity return for its investment.

Subsection (b) would increase the program authorization levels for the Participating Securities program. In Fiscal Year 1999, the authorization level would increase from \$800 million to \$1.2 billion. In FY 2000, it would increase from \$900 million to \$1.5 billion.

Subsection (c) clarifies the rules for determining whether a small business or smaller enterprise qualifies for a debt or equity investment under the SBIC program. This change targets a small business that is not required to pay Federal income tax at the corporate level, but that is required to pass income through to its shareholders or partners. This provision is intended to permit “pass through” enterprises to be treated the same as enterprises that pay Federal taxes for purposes of SBA size standard determinations.

Subsection (d) includes three technical corrections to the Small Business Investment Act of 1958.

The first change removes the requirement that a least 50% of the annual program level of the Participating Securities program be reserved for funding SBICs having private capital of not more than \$20 million.

The second technical correction would require SBA to issue SBIC guarantees and trust certificates at periodic intervals of not less than twelve months.

The third technical change would strike the table of contents from Section 101 of the Act.