



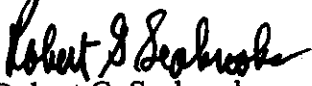
U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

ADVISORY MEMORANDUM
REPORT

Issue Date: March 20, 2003

Number: 3-17

TO: Jeffrey Pierson, Associate Administrator for
Investment Division

FROM: 
Robert G. Seabrooks
Assistant Inspector General
for Auditing

Subject: Complaint by [redacted] * [redacted]

The purpose of this advisory report is to bring to your attention five issues identified during our review of the Investment Division's evaluation of [redacted] * [redacted] (applicant) application for a Small Business Investment Company (SBIC) license. On Monday, June 17, 2002, a representative from [redacted] * [redacted] contacted our office concerning the denial of its application for an SBIC license. The representative stated that he believed the evaluation of the application was overly subjective and did not provide sufficient opportunity for them to present its case for obtaining an SBIC license. Additionally, he stated that they had not received a formal denial letter outlining the deficiencies of its application.

BACKGROUND

The SBIC program fills the gap between the availability of venture capital and the needs of small start-up or growing businesses. Licensed and regulated by the Small Business Administration (SBA), SBICs are for-profit, privately-owned and managed investment companies that make capital available to small concerns through equity and debt-equity investments and loans. They use their own funds plus funds obtained at favorable rates with SBA guaranties. In addition to capital, SBICs also provide management assistance. There are two primary criteria for licensing an SBIC: (a) a capital base of at least \$5 million for debenture SBICs or \$10 million for participating securities SBICs, and (b) having qualified management.

The applicant is a prospective venture capital firm located in [redacted] * [redacted]. An application for a license to operate as an SBIC was submitted in December 2001. In June 2002, an electronic mail message (email) was received which indicated that its application had been denied.

* FOIA Ex. 4

OBJECTIVES AND SCOPE

As a result of receiving this complaint, we initiated an audit with the objective of determining if the Investment Division's (Division) evaluation of this applicant's application and the decision to deny the application were done in accordance with SBA policy. The scope of the audit was limited to a review of the Division's compliance with procedures and criteria used for evaluating the applicant's Management Assessment Questionnaire (MAQ), a pre-licensing/pre-application step in the SBIC licensing process. We reviewed the application information and correspondence, Division policies and procedures, and interviewed officials of the applicant and the Division. Our evaluation was done during the period June to September 2002.

OVERALL EVALUATION

We do not express an opinion on whether the applicant is qualified to receive an SBIC license. The Division's evaluation of the application and the decision to deny were not accomplished in accordance with the existing SBA procedures and criteria. There were five instances during the evaluation process when Division personnel did not comply with the appropriate guidance and one instance when additional criteria were added to the evaluation process. Additionally, we noted that at the time our review started the applicant's principals were not given a formal notification letter explicitly stating the reasons for their denial. Specifics of the issues noted follow.

Appropriate Guidance not Followed

The Division did not follow establish guidance in effect when the application was submitted. Specifically:

- The Applicant's Management Team. The Division determined that the management team did not possess the minimum necessary qualifications. Supplemental guidance issued in March 2002, required that the applicant have at least two full-time managers with five or more years of senior-level (decision-maker) investment experience similar to that contemplated by the prospective applicant. This guidance was issued about three months after the application submission and one month prior to the applicant modifying its application from an SBIC funded with participating securities to an SBIC funded with debentures. The guidance in effect at the time of the applicant's MAQ submission stated that "...highly successful SBICs usually have had management teams with: 1. At least one principal who has five or more years of experience with a venture capital fund...".
- Adequacy of Manager's Experience. The Division determined that the proposed full-time managers' experience in economic development lending was not sufficiently comparable to venture capital investing and, therefore, did not qualify as a substitute for venture capital experience. The general guidance promulgated by the Division at the time of the evaluation was not rigid in the requirement for venture capital experience. This general guidance stated that "a number of successful SBIC managers did not meet the criteria when they received their first licenses". It further stated, "Whether or not you have previously managed a venture fund, during the licensing process, it is up to you to show

how your experience relates...". The phrase "during the licensing process" implies that the applicant is not limited to using the written statements in the MAQ to show how its experience is applicable. The applicant should have been given the opportunity to demonstrate that the experience of its management team was relevant and applicable to operating an SBIC.

- *Accuracy of Manager's Resume'*. The Division expressed concerns about the accuracy of the managing partner's resume', specifically his professional license, professional association, and work history. We found no evidence that, during the evaluation process, the applicant was made aware of the specific concerns about the managing partner's resume' and given the opportunity to address them. After the application was denied and the applicant was informed of the concerns about the managing partner, explanations for the apparent discrepancies were provided. The general guidance states that "at each stage, we will apprise you of our perceptions so that you can know where you stand as you proceed". It also states that the applicant will be contacted regarding any items that are incomplete or unclear. This was not done for the applicant with regard to the accuracy of the manager's resume'.
- *The Applicant's Management Assessment Questionnaire*. The Division did not use draft evaluation criteria to assess and score the applicant's MAQ. The draft criteria addresses key elements to be used to assess the applicant's qualifications, experience, and investment approach. In lieu of using the draft criteria, the analyst elected to deny the application because she believed the MAQ contained material errors and discrepancies and she had concerns about the accuracy of the managing partner's professional licensing, associations, and work history. Per Division management, the draft evaluation criteria were developed in October 2001 for use in assessing and scoring prospective applicants' MAQ and should have been used. Other Division personnel claimed to have used the draft criteria to evaluate other applications received prior to this applicant's submission.
- *Principal's Work Arrangement*. The Division used criteria, location, and number of hours worked, that previously had not been a formal part of the evaluation process. The Division took exception to the proposed part-time and out-of-state work arrangement of one of the applicant's principals. This principal had venture capital experience that appeared to be similar to what was desired by the Division. The principal proposed to maintain full-time employment in the State of Florida and work with the applicant on a part-time basis. The Division decided that this arrangement did not overcome the alleged lack of experience of the full-time managers. We found no guidance requiring a principal to allocate a minimum number of hours or restrictions on outside employment and place of residency. Per Division personnel, other prospective license applicants passed this part of the process without regard to whether the principals allocated a minimum number of hours to the daily operation of the SBIC, outside employment, or place of residency.

Notification of Denial

The applicant did not receive a formal written letter expressing the specific application deficiencies until July 2002. This action was taken after our audit started and the applicant contacted the Administrator and members of Congress. While SBA guidance does not require a formal written notification of denial to applicants, we believe such a formal written notification is warranted to let the applicant know of any deficiencies. An explanation of the reasons for denial will help applicants improve their re-submissions.

RECOMMENDATIONS

We recommend that the Associate Administrator for the Investment Division take the following actions.

- 1.A. Evaluate the new SBIC application submitted by [*] using appropriate policies, procedures and criteria.
- 1.B. Provide a formal written letter to [*], in the event the resubmitted application is denied, stating the specific reasons for the denial.
- 1.C. Incorporate into the standard operating procedures a requirement that when applications are denied, the applicants receive a formal written letter stating the specific reasons for the denial of their application.

Management Response

The Associate Administrator for the Investment Division agreed to take action to implement the audit report recommendations, but disagreed with the conclusions presented in the report. He stated that the OIG failed to review thoroughly the Division's procedures in evaluating the applicant's application and, instead, focused on a few elements rather than the entire process. He stated that the report mistakenly characterizes the guidance as a checklist of specific factors to consider during the evaluation of an applicant. He believes the guidance list general categories and does not set specific requirements. In addition, he stated that: (1) the Division complied with its fiscal and regulatory responsibilities to review the criteria required by the Act to ensure that only applicants with qualified management receive SBIC licenses; (2) the Division's approach in evaluating the applicant's application was contemplated by the guidance, as well as required by the Act; and (3) to have evaluated this applicant or any other applicant by strict checklist would have been contrary to the Division's procedures and the intent of the Act. The full text of the management response is included in Appendix A.

Evaluation of Management's Comments

We disagree with management's comments that the OIG failed to review thoroughly the procedures used by the Division in evaluating the applicant's application, and, instead, focused on a few elements rather than the entire process. Management's basis for disagreeing with the

audit conclusions is that the Investment Division actions were based on requirements in the Act, general criteria, and practices rather than formal written procedures. The conditions identified in the advisory memo either were not addressed in the Act and the general criteria or were the result of the Division not following its guidance when evaluating this applicant's application.

Commonly, the requirements listed in the Act are supplemented by management controls in the form of regulations and standard operating procedures. We noted a lack of regulations and current formal operating procedures amplifying the requirements of the Act and documenting the general criteria and practices applied to this evaluation. Office of Management and Budget Circular No. A-123 defines management controls as organization, policies, and procedures to help program and financial managers achieve results and safeguard the integrity of their programs. The circular also states that the documentation for management controls must be clear and readily available for examination. SBA SOP 00 23 5 states that directives are essential to effective program administration and defines the term directive as any written communication that initiates or governs action, conduct, procedures, or policy for multiple addressees, inside or outside the Agency. The Investment Division's general guidance and practices used to evaluate this applicant's application were management controls that should have been documented in accordance with OMB and SBA requirements.

* * * * *

Please provide your management response to the recommendations within 30 days from the date of this report on the attached Recommendation Action Sheets (SBA Form 1824). Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: February 11, 2003

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

THRU: Ronald E. Bew *for Calgenti*
Associate Deputy Administrator
for Capital Access

FROM: Jeffrey D. Pierson *Jeff D Pierson*
Associate Administrator for Investment

SUBJECT: [*]

This letter responds to the Draft Advisory Memorandum Report ("Report") issued by the Office of Inspector General ("OIG") on December 12, 2002. Although the Investment Division ("Division") agrees with the recommendations contained in the Report, the Division disagrees with the conclusion that the Division did not follow the established guidance in effect in evaluating the application of [*] for a Small Business Investment Company ("SBIC") license.

The Division believes that, as further described below, the OIG failed to review thoroughly the Division's procedures in evaluating [*] application and, instead, focused on a few elements rather than the entire process. We kindly ask you to note the following:

1. The Report ignores the Division's obligation to follow the requirements of the Small Business Investment Act of 1958, as amended ("Act"). Instead, the Report focuses only on the Division's compliance with certain written guidance issued by the Division in evaluating [*] application. That guidance, however, is not the sole criteria that the Division must use in evaluating applications. For example, Section 301(c)(3)(A)(ii) of the Act requires the Administrator of the U.S. Small Business Administration ("Administrator") to determine whether "*the management of the applicant is qualified and has the knowledge, experience, and capability necessary to comply with this Act.*" In addition, Section 301(c)(3)(B)(ii) of the Act directs the Administrator to consider "*the general business reputation of the owners and management of the applicant.*" The OIG Report contains no reference to these requirements.

The Division has a fiscal and regulatory responsibility to review the criteria required by the Act to ensure that only applicants with qualified management receive SBIC licenses. The Division's approach in evaluating [*] application was contemplated by the guidance, as well as required by the Act.

2. The Report mistakenly characterizes the guidance as a "checklist" of specific factors to consider during the evaluation of an SBIC applicant. The guidance lists general categories and does not establish specific requirements for the Division. The evaluation process involves many factors and is not simply a checklist.

To have evaluated [*] or any other applicant by strict checklist would have been contrary to the Division's procedures and the intent of the Act.

3. The Report's finding that the Division erred in considering the supplemental guidance issued in March 2002 has no basis. This finding assumes that the supplemental guidance changed the Division's requirements, when it clarified the guidance in use by the Division. It did not change or add any new requirements.

As the guidance explains, the Division examines three broad categories when it evaluates an applicant. The Division looks at whether an applicant has (i) experience relevant to managing a venture capital fund successfully, (ii) a management team that has worked together or can demonstrate that they are a cohesive, integrated working team, and (iii) a management team that can manage a fund within the SBA regulatory restrictions.

The Division evaluated all of these areas as well as the requirements of the Act in determining that [*] did not possess the minimum necessary qualifications. To have done otherwise would have been contrary to the Division's procedures and the intent of the Act.

4. The Report incorrectly asserts that the Division did not follow its established guidance when it failed to give [*] an opportunity to demonstrate its experience. The Division requires all applicants to complete and submit a Management Assessment Questionnaire ("MAQ"). The MAQ provides applicants with the opportunity to demonstrate the depth and relevance of their experience. The guidance makes clear that "*the burden is on the applicant to demonstrate that the experience of the principals is truly relevant and applicable to running an SBIC.*" The guidance further states that "*during the licensing process, it is up to you to show how your experience relates to the eight aspects of managing an SBIC as enumerated under The Business Plan section.*"

[*] management was offered opportunities through phone calls, e-mails and written submissions to demonstrate the relevance of their experience. The Division followed its established guidance in concluding that [*] failed to demonstrate the adequacy of their experience. To have

done otherwise would have been contrary to the Division's procedures and the intent of the Act.

5. The guidance clearly states that *only if* the Investment Committee finds that the management team may be qualified for a license will the team be invited for an interview. If the OIG suggests that the Division should have invited [*] management for an interview regardless of the Investment Committee's decision, such an invitation would have been contrary to the Division's established procedures. The application procedures do not contemplate interviews before applicants are deemed qualified.

To have invited [*]'s management team for an interview would have been contrary to the Division's procedures and the intent of the Act.

6. The Report states that, during the evaluation process, the Division failed to give [*] an opportunity to address concerns about the accuracy of [*] managing partner's resume. The Report further states that the guidance required the Division to apprise applicants of the Division's perceptions and to contact applicants regarding incomplete or unclear items. In fact, the financial analyst who reviewed [*]'s MAQ informed [*] of the Division's perception of its MAQ. As a result, [*] was permitted to submit two revised MAQs before the analyst presented the application to the Investment Committee.

The Report characterizes items in the managing partner's resume as incomplete and unclear, when they were simply incorrect. An applicant's integrity and credibility are at the core of determining whether an applicant is qualified. The Report seems to suggest that the Division should overlook an applicant's integrity and credibility, and that applicants should be offered multiple opportunities to correct false or misleading information.

To have overlooked the inaccurate statements submitted by [*] would have been contrary to the Division's procedures and the intent of the Act.

7. The Report suggests that the Division should have used certain draft evaluation criteria to assess and score [*] MAQ, rather than follow established procedure. The Report asserts that the analyst elected to deny [*] application in lieu of using draft criteria. The guidance clearly states that the analyst makes a recommendation to the Investment Committee, and the Investment Committee makes the actual determination to invite the principals for an interview.
8. The Report claims that the Division used criteria that previously had not been a formal part of the evaluation process. Specifically, the Report states that the Division looked at location, number of hours worked, and the minimum number of hours that the principals planned to devote to [*]. As the guidance explains, the Division reviews an applicant's business plan according to eight

* FOIA Ex. 4

specific factors. Essential to any analysis of those eight factors is a review of the location, number of hours, and time allocations of the principals.

The Report did not mention the information required by the MAQ and its role in the evaluation process. The MAQ requires all principals to provide their business address and primary work city. The MAQ, in Question 309, specifically requires applicants to "*state the percentage of time that each of the principals will devote to the SBIC.*" Question 310 asks how active the principals plan to be in portfolio companies. Question 322.3 asks whether the principals always or generally meet in person for buy/sell decisions, and whether an applicant intends to permit investment decisions to be made via a telephonic meeting. Question 329 asks applicants to summarize the key roles and functions of each principal.

The OIG appears to suggest that these items have no relevance and cannot be considered in the determination of whether an applicant is qualified. To have failed to consider the location, number of hours, and time allocations of the principals would have been contrary to the Division's procedures and the intent of the Act.

In conclusion, the Division reiterates its position that, while it agrees with the recommendations contained in the Report, it disagrees with the Report's conclusion that the Division did not follow the established guidance in effect during the evaluation of [*] application for an SBIC license.

Thank you for the opportunity to respond to your Report and for your sincere consideration of this matter.

* FOIA EX. 4

Appendix B

AUDIT REPORT DISTRIBUTION

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