



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

DATE: May 4, 2009
TO: All Small Business Investment Companies (“SBICs”) and Applicants
FROM: Harry Haskins, Acting Associate Administrator for Investment
SUBJECT: American Recovery and Reinvestment Act of 2009: Implementation of SBIC Program Changes

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (“Recovery Act”), which makes changes to the Small Business Investment Company (“SBIC”) program. Specifically, Section 505 makes changes in (i) the formula for calculating maximum leverage, (ii) the aggregate investment limitations related to portfolio diversification (“overline” limits), and (iii) the percentage of financings required to be made in smaller enterprises.

The SBA plans to publish regulations implementing these changes in the near future. This memo describes the steps that the Investment Division is taking in the interim.

Maximum Leverage

The Recovery Act changed the formula for calculating the maximum amount of outstanding leverage that can be made available to a single SBIC and to two or more SBICs under common control. Leverage is financial assistance that SBA provides to an SBIC by guaranteeing debt securities (“Debentures”) issued by the SBIC. Some existing SBICs also have outstanding leverage obtained through SBA’s guaranty of an equity-type security (“Participating Securities”), but new leverage in this form is no longer available. In general, under the new formula, the maximum amount of leverage made available to one SBIC may not exceed 300 percent of the SBIC's Regulatory Capital or \$150 million, whichever is less. Regulatory Capital consists of the paid-in private capital of the SBIC, plus any binding capital commitments that the SBIC has received from private investors who meet specified standards of financial net worth (“Institutional Investors” as defined in 13 CFR §107.50). For two or more SBICs under common control, the maximum amount of outstanding SBA-provided leverage cannot exceed \$225 million. The Recovery Act also makes certain changes in this formula for SBICs licensed on or after October 1, 2009 that certify that not less than 50 percent of their investments will be made in companies located in low-income geographic areas.

The leverage application process has two parts. An SBIC must first apply for a commitment to reserve a specific amount of leverage for its future use over a four to five-year period. The SBIC may then apply to draw down leverage against the commitment. All leverage commitment applications and draw approval requests remain subject to

SBA's current credit policies as defined in its standard operating procedures and credit and risk management TechNotes.

(located at http://www.sba.gov/aboutsba/sbaprograms/inv/forsbic/inv_tech_notes.html).

In general, SBA will only approve leverage requests in excess of two tiers of private capital (i.e., more than two times an SBIC's Regulatory Capital) after the SBIC has clearly demonstrated consistent, sustainable profitability based on a conservative investment strategy that limits downside risk. Any such Leverage request must be supported by an up-to-date business plan that reflects continuation of the Licensee's successful investment strategy and demonstrates the Licensee's ability to pay all SBA obligations in accordance with their terms.

Percentage Limitation on Private Capital or Overline Limitation

SBICs that intend to use SBA leverage are required to diversify their portfolios as a way of managing program risk. Diversification is accomplished by limiting the maximum amount that an SBIC can invest in a single company or group of affiliated companies; SBA regulations refer to this maximum investment amount as an SBIC's "overline" limit. The Recovery Act changed the calculation of the overline limit from 20 percent of an SBIC's private capital to 10 percent of the sum of private capital and "the total amount of leverage projected by [the SBIC] in [its] business plan that was approved by [SBA] at the time of the grant of the company's license." Since most SBICs project the use of two tiers of leverage (i.e., leverage equal to two times their private capital), this calculation is generally equivalent to raising the overline limit to 30 percent of private capital. However, for the small number of SBICs that are approved for less than two tiers of leverage, the Recovery Act may provide a smaller increase, or no increase, in the overline limit.

Until regulations implementing this change are published, SBICs should continue to request overline approval, on an individual investment basis, in accordance with 13 CFR §107.740 and TechNote #9.

However, in recognition of the changes to the overline limits made by the Recovery Act, the Investment Division is implementing procedures to expedite the approval process for existing SBICs requesting overline approval. In order to use the expedited approval process, the SBIC must have been licensed with an approved business plan projecting the use of two tiers of leverage and must not have a capital impairment condition as defined in 13 CFR §107.1830 or other unresolved regulatory violations (e.g., unapproved conflicts of interest, investments in ineligible businesses, or any other violations of 13 CFR parts 107 and 121 that have been cited by an SBA examiner), and the aggregate financings and commitments to the small concern in which the investment is proposed and its affiliates, including the overline request, must be below 30% of Regulatory Capital as adjusted to determine the overline limit in accordance with 13 CFR §107.740(a). In these cases, the SBIC will not be required to submit the information required by TechNote #9 but, instead, should submit (i) the amount of its Regulatory

Capital as adjusted to determine the overline limit in accordance with 13 CFR §107.740(a), (ii) the name of the small concern in which the proposed financing is to be made, (iii) the total aggregate amount of financings and commitments made to the small concern and any affiliates prior to the proposed financing, (iv) the total amount of additional financings and commitments for the requested transaction and (v) the SBIC's current actual Capital Impairment Percentage (CIP) and maximum CIP. In all other cases, the SBIC should continue to submit the documents described in TechNote #9.

If an SBIC with an outstanding overline request believes that it meets the requirements for the expedited approval process, the SBIC should contact its analyst.

Finally, SBICs should remember that their limited partnership agreements and other organizational documents may set investment limits that are more stringent than those permitted by SBA regulations. Therefore, any request for overline approval should only be submitted to SBA if the overline is permissible under the SBIC's partnership agreement and other organizational documents.

Investments in Smaller Enterprises

The Recovery Act also changed the percentage of financings which SBICs requesting leverage must provide to smaller enterprises. As defined in 13 CFR §107.710(a), a smaller enterprise is a company that, together with any affiliates, either (i) has net worth of no more than \$6 million and average after-tax net income for its last two fiscal years of no more than \$2 million, or (ii) meets the size standard in 13 CFR §107.201 for the industry in which it is primarily engaged. All SBICs with leverage commitments issued on or after February 17, 2009, must certify that at least 25% of all future financing dollars will be in smaller enterprises. SBA has prepared new commitment and draw applications for those SBICs requesting leverage commitments after February 17, 2009.