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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, House Small Business Committee
From: Sam Graves, Chairman, Committee on Small Business
Re: Full Committee Hearing: "SBA 2012 Budget Request"
Date: February 25, 2011

On Wednesday, March 2, 2011, at 1:00 pm in Room 2360 of the Rayburn House Office Building, the Small Business Committee will meet for the purposes of reviewing the Small Business Administration (SBA) FY 2012 budget. Administrator Mills is scheduled to testify on the President's budget request and other issues related to the overall management of the Agency. The enclosed memorandum discusses various SBA programs and how they are treated in the budget including comparison to prior years. Should you or your staff have any questions, please do not hesitate to contact the Committee's Chief Counsel, Barry Pineles at x55821.

Before addressing the issues in the budget in detail, a very brief overview of the SBA is useful to place the ensuing discussion in an appropriate framework. The agency was created in 1953 by President Eisenhower as a replacement for the Small Defense Plants Administration (an entity created to help maintain a robust small business industrial base for providing goods to the military) and the Reconstruction Finance Corporation (started during the Great Depression as a federal lender to businesses).[1] The mission of the SBA, as evinced in the Small Business Act, 15 U.S.C. §§ 631-57p, is to "aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns…" *Id.* at § 631(a).

The SBA meets its statutory obligation through three major components: 1) assisting small businesses in obtaining needed capital; 2) helping small businesses navigate the federal procurement marketplace; and 3) offering managerial counseling and assistance to small businesses. Each of these components is executed through multiple Congressionally mandated programs, often in conjunction with non-federal "partners."[2] Most of the services provided to small businesses, either by the SBA directly or through

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[1] J. BEAN, BIG GOVERNMENT AND AFFIRMATIVE ACTION 8-9 (2001).
[2] This is the SBA's terminology and covers both for-profit, non-profit, and state governmental entities that help the SBA carry out its mission of assistance to small businesses.

its partners, are delivered through one of the 84 district offices established throughout the United States.[3]

The President has requested $432 million for salary and expenses. This represents a reduction of $65 million from FY 2010. However, this understates the overall salary and expenses because there are separate accounts for administration of the SBA lending and disaster programs. If expenses for those two programs are added to the $432 million, the total for salary and expenses is $575 million, which represents an increase of $20 million from FY2010, all of which stems from an increase in expenses associated with the operation of the disaster loan program.[4] The other primary budgetary driver is the approximately $215 million needed to cover future losses in the major SBA lending programs.[5] As a result, the additional budgetary request for the SBA is about $160 million more in FY 2012 than in 2010.

Capital Access Programs

The 7(a) Loan Guarantee Program

The 7(a) Loan Guarantee Program (named after § 7(a) of the Small Business Act, 15 U.S.C. § 636(a)) serves as the SBA's primary business loan program to assist small businesses obtain financing when they may not be able to obtain sufficient credit from normal lending channels.[6] Loans are not made directly by the SBA; rather the SBA issues guarantees of repayment of loans made by commercial lenders. The size of the guarantee is related to the size of the loan with guarantees of 85 percent for smaller loans (those under $150,000) and 75 percent for loans in excess of $150,000. The American Recovery and Reinvestment Act (ARRA) temporarily authorized, but did not mandate, the SBA to increase the guarantee for all loans to 90 percent.[7] Maximum loan size used to be set at $2 million dollars but that upper-level cap was increased in Title I of the Small Business Jobs Act of 2010, Pub. L. No. 111-240, to $5 million.[8] Interest rates vary depending on the size of the loan with the largest loans having the lowest interest rates (usually 2.25 or 2.75 percent above prime depending on the maturity date of the loan).

The SBA is authorized to charge an up-front guarantee which will vary depending on the size of the loan with a maximum cap of 3.75 percent of the amount guaranteed.

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[3] Each state and territory has at least one district office. In larger states, there are multiple district offices, including smaller so-called branch offices. This distinguishes the SBA from most other federal agencies that provide services locally through one of ten federal regional headquarters.
[4] The request for additional disaster loan administration funds will be discussed later in this memorandum. The actual request for increased disaster funding is $90.7.
[5] Accounting for costs of federal lending programs under the Federal Credit Reform Act will be discussed later in this memorandum.
[6] K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, THE HANDBOOK OF FINANCING GROWTH 146 (2005).
[7] The Small Business Jobs Act of 2010, Pub. L. No. 111-240, extended the authority to grant 90 percent guarantees through December 31, 2010. The President has not requested further extension of the larger guarantee percentage.
[8] With a maximum gross loan amount of $5 million and a guarantee percentage of 75 percent, the SBA will guarantee up to 3.75 million dollars for a small business loan under the 7(a) loan program.

15 U.S.C. § 636(a)(18(A). For example, a borrower having a gross loan amount of $3 million with a 75 percent guarantee (a SBA-guarantee amount of $2.25 million) would pay $84,375 as the guarantee fee (.0375 * 2.25 million).[9] In addition to this up-front guarantee fee, there also is an ongoing guarantee paid by the lender to the SBA and amounts to 0.55 percent of the unpaid balance of the guaranteed portion of the loan. *Id.* at § 636(a)(23). The ARRA provided funds (extended by the Small Business Jobs Act of 2010 until the end of calendar year 2010) to reduce these fees first of those ultimately paid by the borrower and then, if funds remained, the ongoing guarantee fee. The President's FY 2012 budget does not request an appropriation for continued funding of these fee reductions.

Any lender is eligible, after receiving approval from the Administrator, to originate loans for which the SBA will issue a guarantee. A subset of these lenders, denoted "preferred lenders," has substantial expertise with the SBA lending programs and regulations. Preferred lenders are authorized to approve loans using documentation and loan forms developed by the SBA to issue guarantees without first submitting the loan packages to the agency for approval.

In addition, preferred lenders may utilize the Express Loan program, *id.* at § 636(a)(31), in which the preferred lender may use their own forms and documentation but only will be eligible for a 50 percent guarantee of loans up to $350,000[10] from the SBA rather than the normal 75 or 85 percent. Even though the guarantee percentage of a loan is lower, the government runs a substantial risk from the Express Loan program because the quality of loan documentation is not as substantial as in the normal 7(a) loan program.

Before leaving the discussion of the 7(a) loan program, it is necessary to discuss another new lending program – floor plan financing. Using inventory that is sold to consumers as collateral for a loan to enable a business to purchase inventory is a common financing technique used by car, boat, recreational vehicle, furniture, and appliance dealers, among others. This is called floor-plan financing because the businesses are purchasing inventory that will placed on their showroom floor. Historically, the SBA did not permit the use of loan proceeds to purchase inventory, even if the inventory is used as collateral for the loan. *See* 13 C.F.R. § 120.130(c) (2008). In 2009, the SBA created a pilot program (without Congressional authorization or comment from the public) to permit floor plan financing for products that receive titles from states, such as automobiles,

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[9] By statute, the lender actually pays the fee but the lender is permitted to charge the cost of the fee to the borrower. 15 U.S.C. § 636*(a)(18)(A). From the perspective of the borrower, this up-front guarantee fee is similar to points that would be paid on a residential mortgage but, unlike that case, the legal obligation to pay the fee rests with the lender.

[10] In the Small Business Jobs Act of 2010, loan limits for the Express Loan program were raised for one year to a maximum of $1 million. The rationale for the Express Loan program (somewhat defeated by increasing the loan size) is that the processes and documentation to approve a normal SBA loan are sufficiently time consuming that banks cannot make a profit on such small loans. Another advantage to the banks is that the ongoing cost of Express Loans are lower since the outstanding guarantee amount for a loan will be less (0.55 percent of a 50 percent guarantee will be less than 0.55 percent of the same size loan with an 85 percent guarantee). A significant component of SBA lending is done by large preferred lenders through its Express Loan program.

boats, manufactured homes, and motorcycles. The Small Business Jobs Act of 2010 created a statutory authorization for the program and limited it to automobiles, recreational vehicles, boats, and manufactured homes.

The Certified Development Company Program

The Certified Development Company (CDC) Program provides long-term fixed rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization as long as the loans[11] meet certain policy and job creation standards. The program was created by Congress in Title V of the Small Business Investment Act of 1958, 15 U.S.C. §§ 695-97g, and is referred to colloquially and incorrectly as the "504 Loan Program."[12] This loan program is set up in which the small business contributes 10 percent of the value of the project, a commercial bank contributes 50 percent,[13] and a certified development company or CDC contributes 40 percent through the issuance of a debenture whose repayment is guaranteed by the federal government. The maximum size of the debenture that can be issued by a CDC will vary depending upon the purpose of the project and the type of borrower,[14] one general statement is that CDC lending can finance significantly larger projects than those available under the 7(a) loan program. Interest rates on CDC debentures are pegged to an increment above the interest rate for 5- and 10-year Treasury notes. As with 7(a) loans, there is a fee structure but it is a somewhat more complicated calculation of various fees paid by borrowers, first lien lenders, and the CDC. 15 U.S.C.§ 697(b)(7), (d).

Historically, CDC loans could not be used for purposes of refinancing existing debt.[15] The rationale behind the prohibition was that refinancing, while potentially beneficial to the business to reduce debt, was not a key component of economic development that led Congress to create the CDC program. The Small Business Jobs Act of 2010 created a two-year temporary authorization to permit CDCs (using the same basic lending structure outlined above) to refinance existing non-governmental debt, i.e., debt not issued by the SBA or any other federal agency. Unlike a normal CDC loan which requires that the

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[11] K. MARKS, L. ROBBINS, G. FERNANDEZ & J. FUNKHOUSER, THE HANDBOOK OF FINANCING GROWTH 147 (2005).

[12] Section 504 of the Small Business Investment Act of 1958, 15 U.S.C. § 697a, authorizes the SBA to securitize instruments issued by Certified Development Company (CDCs) and sell them to private investors. The reference is a misnomer because the authority of CDCs to make loans and the purposes for which such loans can be made is found in § 502 of the Small Business Investment Act of 1958, 15 U.S.C. § 696. The incorrect nomenclature has been a longstanding complaint of the Committee under both Republican and Democratic Chairs because that does not adequately reflect what the loan program does. However, the SBA remains resistant to modifying the nomenclature because it would upset standard industry practice.

[13] If the borrower fails to pay and there is a bankruptcy proceeding, the commercial bank lender will be paid back before the federal government. The bank then is considered to hold a first lien on the property.

[14] The sizes of the debentures are $1.5 million if the project does not meet certain statutory goals, $2 million if it meets certain goals, and $4 million dollars for loans to small manufacturers. The Small Business Jobs Act of 2010 raised these limits to $5 million for most projects and $5.5 million for certain projects of small manufacturers. Thus, for a project with a $2 million dollar debenture, the project size is actually $5 million ($2 million debenture, $2.5 million from a commercial bank lender, and $500,000 from the borrower).

[15] For businesses seeking to refinance existing debt, they would have to utilize the 7(a) loan program.

loan create or save jobs, the CDC refinancing requires no job creation or savings at all. Furthermore, the program permits loans issued in the past two years that are not more than 30 days in arrears to obtain refinancing. All other aspects of the CDC loan program apply to this refinancing initiative.

The ARRA created a subsidiary program within the broader CDC program to boost lending in this program. It authorized the SBA to guarantee repayment on the first-lien loans made by commercial bankers that are part of the overall CDC loan package. The poolers of such loans are required to pay fees for the guarantee of the pools of the first liens sold to private investors.[16]

Unlike the 7(a) loan program, the vast majority of loan packages in the CDC must be approved by the SBA. Of the approximately 270 authorized CDCs in the United States, only a handful are designated as "Premier Certified Lenders" or PCLs which are entitled to approve loan packages without first submitting the loans to the SBA.[17] These PCLs also have the authority to liquidate (just as preferred lenders do in the 7(a) loan program) loans that go into default without the assistance or approval of the SBA.

Microloan Program

When starting a business, the vast majority of these very small businesses do not actually utilize banks to take out commercial loans. Rather, they rely on loans and contributions from relatives (colloquially referred to as "angels" or "angel investors") and revolving credit loans using their own credit cards. There are some potential entrepreneurs that cannot even rely on angels or revolving credit to find funds for their startups. The Microloan Program is designed to provide credit for those entrepreneurs that would not otherwise have any access to credit, even revolving credit.

Microlending was first developed by Muhammad Yunus in Bangladesh. The establishment of the Grameen Bank and its replication in other countries of South and Southeast Asia won Dr. Yunus the Nobel Peace Prize in 2006.

The SBA jumped into the mix with a pilot program in 1991. Congress then created a statutory microloan program to assist low-income individuals who do not have the financial or technical resources needed to start and operate a small business. In the 1997 reauthorization, the Microloan Program became permanent. Since the introduction of

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[16] As with any securitization of any credit instruments, the primary purpose is to increase liquidity by removing the loans from the banks (so they do not have to retain capital to cover potential loan losses) in order to increase lending. T. KOCH & S. MACDONALD, BANK MANAGEMENT 41 (2006).

[17] The primary rationale for the establishment of PCLs no longer exists. Historically, it took the SBA up to 3 months of review at a SBA district office to approve a CDC loan package. PCLs avoided these delays because they could approve loans without SBA review of each individual loan. However, the cost of this authority was a requirement that the PCL maintain larger loan loss reserves than other CDCs. The SBA, after intercession and complaints by the Committee on Small Business in 2003-04, centralized review of CDC loans in its Citrus Heights, CA loan processing facility. The time frame for processing such loans has now dropped to anywhere from 2 to 5 business days. Without significant delay and no requirement for additional loan loss reserves, very few CDCs have sought the authority to be a PCL.

microfinance programs in the United States, the number of organizations providing direct services to entrepreneurs as microdevelopment organizations or MDOs is about 550. Of these, only about 175 operate as intermediaries in the SBA program. Typically intermediaries make about 2,500 loans each year to borrowers with a total value of about $32 million. The default rate on loans by the SBA to intermediaries is close to zero. The default rate for borrowers from intermediaries is quite low – although not as low as that on the 7(a) loan program.[18]

As with all SBA financial assistance programs (except disaster loans), the SBA does not make a microloan directly to a small business. Rather, it makes a loan to a non-profit called a microloan intermediary. These loans are made at interest rates 1.25 percent below the market rate for 5-year rate for United States Treasury notes. Intermediaries are prohibited from obtaining all of their loan funds from the federal government. At least 15 percent of funds made available for loans must come from sources other than the federal government.[19] 15 U.S.C. § 636(m)(3)(b). Unlike the 7(a) and CDC loan programs, appropriated funds cover the cost of subsidizing the interest rate differential in the Microloan Program. The intermediary, in turn, makes loans of up to $50,000 to borrowers.[20] Loans in excess of $20,000 only can be made if the borrower can demonstrate that comparable credit is not elsewhere available. *Id.* at § 636(m)(3)(E). Borrowers then repay the intermediary which in turn repays the SBA. Unlike the banks operating in the 7(a) loan guarantee program, the SBA requires that the intermediaries provide education and training to its borrowers. The intermediaries can provide such training or contract for some other enterprise to provide training and counseling.[21] Funds for training and counseling are provided, in part, by appropriated funds made available to the intermediaries.

Small Business Investment Company Program

Small business investment companies (SBICs) are for-profit enterprises organized under state law as either a corporation or partnership or a variant thereof. SBICs receive a

[18] The SBA readily admits that it does not have good data on the default rate of loans made by intermediaries.

[19] In this regard, the Microloan Program is no different than the other SBA-sponsored financing programs. The 7(a) loan program requires that a bank put up anywhere from 15 to 50 percent of each individual loan depending on the size and duration of the loan. CDC loans require the borrowers to obtain financing from sources other than the debenture provided by the SBA. Small business investment companies must provide their own capital before obtaining leverage from the SBA.

[20] Maximum loan size in the program was $35,000 before it was raised in the Small Business Jobs Act of 2010 to $50,000. In selecting intermediaries for the program, the SBA is to give preference to those intermediaries who will maintain an average loan size in its portfolio of $10,000. 15 U.S.C. § 636(m)(3)(A)(ii). The rationale behind this is twofold. First, it ensures that intermediaries actually focus on microloans rather than normal commercial loans. Second, an average loan limit size of $10,000 prevents intermediaries from competing with banks operating the 7(a) loan program using subsidized interest rates.

[21] The training and counseling requirement is direct adaptation of the model followed by Grameen Bank in making credit available to its borrowers. Dr. Yunus recognized that its borrowers needed significant advice on how to manage money in order to create a small business that could repay loans. However, in Bangladesh and other foreign countries that have duplicated the Grameen Bank model, the lender became the only available entity to provide such advice.

license to operate from the SBA pursuant to authority in Title III of the Small Business Investment Act of 1958. The SBA may not grant a license until it is satisfied that the licensee has: a) sufficient capital to operate soundly and profitably; and b) has qualified management. 15 U.S.C. § 681(c)(3)(A). If the SBA is satisfied with these aforementioned determinations, then the agency, prior to issuing a license, must consider whether: a) there is a need for investment in the area in which the applicant will operate; b) the reputation of the owners of the applicant; and c) the prospect that the ownership will manage the business in a profitable manner. Once the SBA is satisfied, it will then issue a license. Thus, the licensing process requires the SBA to consider the business plan of the SBIC before issuing a license. *See* 13 C.F.R. § 107.130.

The SBA licenses two types of SBICs – debenture SBICs and participating security SBICs. The primary difference between debenture SBICs and participating security SBICs is in how the entities repay the federal government for their leverage. The divergent repayment schedules lead the SBICs to invest at different stages of a company's development.

Some of the most famous names in corporate America, including Nike, Dell Computer, Federal Express, Callaway Golf, and Outback Steakhouse, were recipients of debenture SBIC funding. These companies were established and utilized debenture SBIC funding for expansion because they had sufficient cash flow to repay the SBICs that in turn could repay their leverage borrowing from the SBA. In essence, the basic philosophy of the debenture SBIC is to invest in companies in which the return on the investment will be split between an increase in the value of the company and monetary payments back to the SBIC.

The structure of repayments in the participating SBIC program leads to a very different type of investment. Since the requirements of repayment are not as immediate in this program as in the debenture SBIC program, these SBICs may invest in firms that are startup firms, rather than established firms looking for expansion capital. In essence, participating security SBICs receive the bulk of their investment payback in the growth of the value of the companies in which they invest. One such successful investment by participating securities has been Build-a-Bear. It goes without saying that investments relying solely on an increase in the value of a company are going to be more volatile than investments in companies that can pay a "dividend" as a well as have some growth. Volatility, however, does not lead to consistent returns and that has created significant problems for the participating security firms leading to potential significant losses.

Once licensed, the SBIC is able to draw leverage in tiers. For every dollar of private investment, an SBIC is entitled to draw up to three dollars in government funding (but is not required to draw that maximum amount). The leverage derives from securities that are sold in the private market (essentially a loan by private investors to the SBIC) and the federal government guarantees that the "lenders" to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage. In essence, there are two separate "loan" transactions; a loan of leverage by the SBA to the SBIC and a loan of private funds by investors to the SBIC who receive either a debenture or participating

security (depending on the type of SBIC) to the total value of funds provided by the private investors as "collateral." The SBA guarantees the repayment of the funds provided to the SBIC by the private investors who purchased the leverage. As with the 7(a) and CDC loan programs, there are fees paid upfront by the investment company (a fee up to 3 percent of the value of the leverage to purchase a commitment of leverage), 15 U.S.C. § 683(i), and an ongoing fee for the SBA's guarantee which is paid as additional interest charge on the amount owed to the government by the SBIC for the issuance of the leverage. *Id.* at § 683(b).

The SBA also imposes significant oversight and control on the operations of SBICs primarily through its control on the issuance of leverage. The SBA only will issue leverage (even if the SBIC has purchased a commitment for leverage) when the SBIC demonstrates that it needs the leverage. *Id.* at § 107.1120(a). Nor will the agency issue leverage if it determines that the issuance of the leverage will unduly place the government at risk of loss. *Id.* at § 107.1120(c)(2)(ii). The SBA also conducts examinations of licensees to ensure they are compliance with all applicable regulations and ensure that they are not placing the government at undue risk. *Id.* at § 107.690. SBICs are limited in the amount of funds that may be invested in anyone company. *Id.* at § 107.740. Finally, the SBA can stop the SBIC from making investments if the investment losses are sufficiently severe to place the company in "capital impairment." *Id.* at § 107.1830-50.

Disaster Loan Program

The SBA provides the primary financial resource for those homeowners, small businesses, and small not-for-profit organizations[22] attempting to recover from a disaster. The vast majority of disaster loans are physical disaster loans (loans to replace buildings destroyed as a result of a disaster) provided to homeowners for losses not otherwise covered by either private insurance or that purchased pursuant to the National Flood Insurance Program. Small businesses also are eligible for physical disaster loans. In addition, small businesses (whether their place of business was destroyed or not) also are eligible for economic injury disaster loans (loans to cover the costs while the business and area recover).[23] A small business is limited to a maximum loan amount of $2.0 million for a combination of physical and economic injury disaster loans.[24] Loans made under the disaster loan authority are made directly by the SBA[25] to borrowers so in this regard it is different than other SBA capital access programs.

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[22] Small not-for-profit organizations were added by § 12061 of the Food Conservation and Energy Act of 2008, Pub. L. No. 110-234, 122 Stat. 1406 (2008) (hereinafter Farm Bill).

[23] Businesses can obtain so-called "business interruption" insurance. To the extent that a business has such insurance, the amount of an economic injury disaster loan would be reduced by the coverage afforded under the business interruption insurance policy.

[24] Until June 18, 2008, the amount of disaster assistance awarded to small businesses was limited to a total of $1.5 million. Section 12078 of the Farm Bill increased the overall disaster loan amount to $2.0 million. That same section of the Farm Bill authorized the SBA to waive the $2.0 million cap.

[25] There are exceptions to the SBA making direct loans. In case of disasters on the scope of Hurricane Katrina, the private banks may be authorized to make disaster loans at below commercial rates with the

Finally, small businesses are eligible for the Immediate Disaster Assistance program created by § 12084 of the 2008 Farm Bill. The program enables small businesses to receive loans under $25,000 from private banks with 85 percent of the loan guaranteed by the SBA. Businesses must otherwise be eligible to receive a disaster loan from the SBA and if the business ultimately receives a disaster loan from the SBA, it must use the proceeds to immediately pay back the immediate assistance loan. The idea of the program was to let eligible small businesses get some assistance from private banks that would be able to process loans more quickly than the SBA.[26]

Not all businesses located in a declared disaster are eligible for a SBA disaster loan. First, only businesses that do not exceed the threshold size standards set forth in the agency regulations, *id.* at § 121.201, are eligible to receive assistance from the SBA. Second, Congress prohibits the SBA from lending to people not legally in the country, people who have not filed tax returns (or owe the federal government back taxes), or are not current on child support payments. Finally, the disaster loan program is a loan program and the SBA is required by statute to reject any loan applicant who, in the agency's determination, is unlikely to have the resources to repay the loan.

The Federal Credit Reform Act and SBA Capital Access Programs

The Federal Credit Reform Act (FCRA), 2 U.S.C. § 661, requires government agencies to estimate the net present value cost to the government of any loan program that the agency operates. In the case of the SBA, the agency is required to comply with that standard for all of its capital access programs. Essentially, the FCRA requires that SBA receive in income (be it through an appropriation or from fees paid by lenders and borrowers or some combination of both) sufficient monies to cover any losses[27] in its capital access programs for any loan made in the fiscal year for which the net present value of the cost is calculated. For example, if the SBA plans on making $10 billion in its 7(a) loans for FY 2012 and estimates that net present value of the cost to the government (loan defaults)[28] will cost the government $100 million, the agency must receive $100 million dollars in FY 2012 to cover that cost (this is the so-called subsidy rate).[29] Each separate capital access program has its own subsidy rate.

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difference being paid by the federal government to the private lenders. 15 U.S.C. § 636(c). Since being authorized, the SBA has never used this authority.

[26] It is important to recognize that the overwhelming number of loans made by the SBA after a disaster are physical injury loans made to homeowners whose property was destroyed.

[27] Losses are calculated by taking the net present value of defaults and subtracting out the net present value of recoveries, i.e., the value of collateral received by the government from defaulted loans.

[28] It is important to note that it is not the loans that go into default in FY 2012. It is the loans that were made in FY 2012 that go into default at some point in the future that is the cost being estimated under the mandate of the FCRA.

[29] The subsidy rate goes down when the amount of income needed to cover losses goes down and the subsidy rate goes up when the amount of fee income needed to cover losses goes up.

Capital Access Programs and FY 2012 Budget

The President's budget notes that its request is approximately $500 million less than that for FY 2011 or the funds actually consumed through the end of calendar FY 2011. Almost all of that reduction stems from the decision to not fund programs created, including reductions in fees paid by borrowers, in the ARRA since the authority to expend such funds expired on December 31, 2010. It is hard to call the elimination of special appropriations that cease to operate after December 31, 2010 a reduction in spending.

While eliminating funds associated with lending enhancements created in the ARRA, the FY 2012 budget for the SBA actually increases funds needed to operate the largest SBA lending programs – the 7(a) and CDC Loan Programs. Since 2004, the fees needed to operate those programs, as well as the SBIC program, were sufficient to cover the expected losses in the program.[30] Since they received no appropriated funds to cover their costs under the FCRA,[31] the programs were denominated as "zero-subsidy."

Appropriations Needed to Fund Lending Programs

That however is no longer the case for the 7(a) and CDC loans. Three major factors have affected loss of the zero-subsidy in these two lending programs. First, the economic downturn increased the SBA's estimate of future defaults (businesses unable to repay their loans). Second, the expected value of collateral recovered is expected to go down as a result of declining real estate values.[32] Third, there are statutory caps that prevent the SBA from raising fees to obtain sufficient fees to cover the costs in lieu of needing an appropriation. Thus, the FY 2012 budget requests $129.8 million to cover about $16.5 billion in 7(a) loans and $81.8 million to cover an expected $7.5 billion in CDC lending. If these funds are appropriated and the SBA does less lending, the funds either will be returned to the Treasury or used as a carryover to reduce costs of these loan programs in FY 2013. On the other hand, if there is unexpected demand and the SBA expects to lend past those levels, it will have insufficient funds to lend and will either have to curtail the programs or modify lending amounts to ensure that those limits are not exceeded.[33]

This request actually may underestimate the cost of the CDC loan program. As already mentioned, small businesses will be able to use the CDC loan program to refinance

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[30] The one exception is the participating security program; fees were unable to cover losses in the program and neither the Bush nor Obama Administration sought funds or an increase in fees to cover new issuance of leverage in the program. Except for the winding up of extant participating security SBICs, the program has been dormant since 2004.

[31] The SBA received appropriated funds to operate the programs (salary and expenses) but those costs are not included in the calculus required by the FCRA.

[32] This is particularly problematic in the CDC program which relies heavily on commercial real estate to collateralize loans.

[33] This occurred in late 2003 and early 2004 when unexpected demand in conjunction with a continuing resolution forced temporary reductions in loan sizes to conserve funds to cover loan costs under the FCRA.

existing debt which would basically be existing commercial real estate mortgages. The value of such property has been hit almost as hard as the residential real estate market. Thus, the value of collateral that the SBA would collect under on a defaulted refinanced commercial real estate mortgage could go down. Despite this evident risk of default and reduced collateral (a risk that shows in the increased appropriations to fund the conventional CDC loan program), the FY 2012 budget contends that this refinance program will not require a subsidy. The basis of this claim really is the additional fees charged to borrowers under this program – fees that the SBA may not have the authority to assess.[34] If the SBA does not have the authority to charge that fee, then the cost of the CDC refinance program will simply add to the existing cost of the CDC program and the funds requested may be inadequate to cover the cost of loans made in FY 2012.

The Disaster Loan Program also has a subsidy rate, i.e., the SBA needs an appropriation to cover the costs of loans. However, there is no request for funds because the Disaster Loan Account at Treasury is a revolving fund that is replenished when loans are repaid. In short, the SBA typically has sufficient carryover funds to cover disasters expected in a normal year. For large scale disasters, such as a Hurricane Katrina, the carryover funds would be insufficient to cover the financial needs of homeowners and businesses. In such cases, Congress normally makes emergency appropriations to cover such disasters.[35]

There are two types of subsidies for the Microloan Program – appropriated funds so that intermediaries can provide counseling to borrowers and the funds needed to subsidize the interest rates at which loans are made to the intermediaries by the SBA. The size of the counseling request is four times the size of the loan subsidy request in the FY 2012 budget. Thus, the limitation on lending in the Microloan Program is a function on the funds available to counsel the small business borrower. A key question on this issue is whether the extensive entrepreneurial outreach programs overseen by the SBA would serve as an adequate substitute for counseling funds appropriated directly to intermediaries.

One item highlighted in the FY2012 Budget for savings is a reduction of $20 million in the further development of the Loan Management Accounting System (LMAS). Congress mandated that the SBA have a fully functioning LMAS by 1997. Nearly 15 years later the functionality mandated in the Small Business Act still has not been achieved by the agency. The system is so old and outdated that it uses the COBOL

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[34] Under the SBA regulations published on February 17, 2011, the SBA is adding "a supplemental annual guarantee fee" of .294 percent to cover the cost of the CDC refinance program. However, the section of the SBA's regulations that are being amended to cover this program relates to a fee that has a statutory cap of .9375 percent. *Compare* 76 Fed. Reg. 9218 (2011) *with* 15 U.S.C. § 697(b)(7). It is not apparent from the SBA's Federal Register notice the authority for exceeding a statutory cap on the fees. Nor does the authorization in the Small Business Jobs Act of 2010 make it clear that the additional fees are those designed to drive the subsidy rate for refinancing to zero.

[35] While it might make sense to budget for such large scale disasters, it would be impossible to predict when such disasters occur or how much would be needed. For example, despite advances in seismology, it still remains impossible to predict when an earthquake will occur in the United States or the severity of such earthquake. Maintaining large amounts of funds in an account in the Treasury for an event that may or may not occur in any given year would not be the most efficient use of scarce federal resources.

programming language. Furthermore, the existing system is a proprietary system managed by Unisys Corp. The funds requested in the FY 2012 are designed solely to migrate the system to a non-proprietary COBOL system by the end of calendar year 2011. No additional funds for software updates or improved functionality were requested. If the LMAS is insufficiently robust, it raises serious questions about the adequacy of SBA's ability to manage a total loan portfolio in excess of $80 billion.

Due to the way the Small Business Act was drafted, salaries and expenses associated with the operation of the lending and disaster programs are not incorporated into the overall salaries and expense account for the operation of the SBA. In the budget, the SBA reduces funds for administration of the non-disaster lending program by $5 million. However, the SBA requests an additional $91 million dollars for the operation of the disaster loan program. While the SBA has the ability to move unused disaster loan funds for administration of the program, the FY 2012 Budget request can be viewed as a statement that such sums have run out. However, there is very little detail in the Budget on exactly how such funds shall be used. Thus, it is impossible to assess whether the request is an appropriate level, underfunds operations, or overfunds administration of the disaster loan program.

Ways to Achieve Savings in Capital Access Portion of SBA FY 2012 Budget

As already noted, one of the key components of the subsidy rate calculation involves the amounts recovered on defaulted loans. The return on SBA's liquidation of CDC loans is approximately 20 cents on the dollar. This is not a good return and raises the subsidy rate for the program (as is evidenced by the SBA request for an appropriation to cover loan costs in the program). One solution that has been proffered in the past and, was overwhelmingly passed in a bipartisan manner by the House, has been to authorize CDCs to perform their own liquidations and reimburse them for the costs associated with that process. Yet the FY 2012 budget request does not incorporate that solution which would improve returns to the federal government on defaulted loans while at the same time reducing the funds that must be appropriated to operate the CDC loan program.

The Standard Operating Procedures, or SOPs, that provide guidance to the lenders run to around 500 pages (this is a significant reduction from about 1,000 pages before a massive rewrite). According to the SBA's regulations, lenders must comply with the SOPs in closing loans. As a result, these SOPs then constitute regulations (an exegesis on the distinctions over the different type of regulations enumerated in the Administrative Procedure Act is beyond the scope of this memorandum) that limit the discretion of the SBA and its lending partners. Yet, the SOPs are not promulgated according to the procedures mandated by the Administrative Procedure Act for regulations as already discussed elsewhere in this memorandum. If that is the case, the SBA is regulating by guidance which violates both the Administrative Procedure Act, *see Appalachian Power Co. v. EPA*, 208 F.3d 1015 (D.C. Cir. 2000), and the Agency's own regulations on public participation, which also constitutes a violation of the Administrative Procedure Act.[36]

[36] It is an abecedarian principle of administrative law that an agency must follow its own regulations. *United States v. Nixon*, 418 U.S. 683, 695 (1974); *Cherokee Nation v. Babbitt*, 117 F.3d 1489, 1499 (D.C.

This issue needs to be addressed in any reauthorization. More importantly, these ad hoc changes may impose significant costs on lenders as they need to change their processes and procedures. The SBA offered nothing in its budget to address the costs associated with the promulgation of SOPs.

The Small Business Act authorizes the SBA to create new lending initiatives not specifically authorized by statute. These are called pilot programs, and the SBA establishes them by placing a notice in the Federal Register and modifying a lengthy the SOPs. The SBA claims it has the authority to conduct these programs pursuant to 13 C.F.R. § 120.3 (a regulation of the agency that permits it to waive any regulation on a temporary basis). Nevertheless, the SBA uses this authority to implement major permanent regulatory changes using temporary regulatory authority, such as the Community Express Loan program that has been in existence since 1999 under this temporary authority. And these programs, such as Community Express (which the SBA admits is costly and is being revamped because of the adverse consequences it has on the subsidy rate for the 7(a) loan program), often add significantly to the subsidy cost of various loan programs even though there has been no input from Congress or the public about the design of these programs. The FY 2012 Budget Request has not provided any process for reducing the adverse budgetary impact of these ad hoc pilot programs.

Government Contracting Programs

The goal of the federal procurement system is: "to deliver on a timely basis the best value product or service to the customer, while maintaining the public's trust and fulfilling public policy objectives." 48 C.F.R. § 1.102(a). To achieve this objective, the basic premise is that open competition among the largest number of potential government contractors will be the best method for achieving the goal of the federal procurement system. 48 C.F.R. § 6.101.[37]

The starting point for federal procurement then is full and open competition. However, it is not the end point as well. Congress determined that it could accomplish other relevant public policy objectives through federal government procurement. Another objective is to promote the growth of small business by ensuring that they receive "fair proportion of the total purchases and contracts for property and services for the Government in each industry category...." 15 U.S.C. § 644(a).

Cir. 1997). If an agency fails to follow its regulations, that constitutes arbitrary and capricious agency action that can be overturned in court. *Morton v. Ruiz*, 415 U.S. 199, 235 (1974); *Neslon v. INS*, 232 F.3d 258, 262 (1st Cir. 2000).

[37] The cited section of the Federal Acquisition Regulation implements § 2711 of the Competition in Contracting Act (colloquially known among the government contracting cognoscenti as CICA) which requires, except as otherwise provided by statute, full and open competition. 41 U.S.C. § 253. CICA's use of the term "full and open" was designed to ensure that all government contractors (and not some limited subset selected by contracting officers) had the opportunity to bid on the provision of goods and services. 48 C.F.R. § 2.101; *accord* J. Chierichella & J. Aronie, MULTIPLE AWARD SCHEDULE CONTRACTING 68 (2006).

To achieve this objective, Congress created a number of programs designed to increase opportunities for small businesses. The Small Business Reserve Program requires that contracts of value between $3,000 and $100,000 be set aside only for competition among small businesses if at least two small businesses can perform the contract at a fair market price. 48 C.F.R. § 19.502-2. The other programs are targeted at specific classes of small businesses: 8(a) businesses; HUBZone businesses; service-disabled veteran-owned businesses; and women-owned businesses. The programs also enable contracting officers to limit competition to businesses within a specific category and in all cases, except small businesses owned by women, to award contracts on a sole source basis, i.e., without competition at all.

The 8(a) Program

This program assists socially and economically disadvantaged (generally minorities) small businesses and is colloquially referred to as the "8(a)" program after section 8(a) of the Small Business Act, 15 U.S.C. § 637(a). The program is designed, not solely as a contracting program, but as a business development program. 13 C.F.R. § 124.1. The primary mechanism for providing business development is to obtain federal government contracts for program participants. Technical assistance is provided to program participants pursuant to § 7(j) of the Small Business Act, 15 U.S.C. § 636(j).

Section 8(a) authorizes the SBA to enter into contracts with other federal agencies to provide goods and services to the government. The SBA then enters into a contract with a firm that has been certified pursuant to the 8(a) program to provide the goods and services. In essence, the SBA becomes the prime contractor to the federal agency and the 8(a) firm becomes the subcontractor to the SBA. *Contract Management, Inc. v. Rumsfeld*, 434 F.3d 1145, 1147 (9th Cir. 2006).

Contracts under the 8(a) program may be awarded as a sole source contract or in a competition solely reserved for firms certified to participate in the program. It is important to note that the SBA delegated its authority to enter into two contracts with firms in the program to other federal agencies. Thus, the agencies now enter into contracts directly with 8(a) participants rather than negotiating with the SBA as the prime contractor. This change was made during the Clinton Administration and contravenes the specific language of the Small Business Act requiring that the SBA and the federal agency enter into a prime contractor relationship.

SBA regulations define who is socially and economically disadvantaged. 13 C.F.R. §§ 124.103, .104. Participation is limited to nine years from the date of entry of the program. Participants may "graduate" if the firms have spent nine years in the program or have achieved the objectives set forth in the business plan that they file with the SBA when they enter the program.

Many graduates of the 8(a) program do not succeed when they graduate. The possible reasons for the lack of success may include overreliance on non-competitive government

contracts or the absence of adequate technical assistance that ensures capacity to operate in normal commercial or federal contracting markets.

HUBZone Program

The Historically Underutilized Business Zone (HUBZone) program was created in 1997 to provide federal government contracting opportunities to small businesses located in geographic areas where unemployment has been above the national average. *Metro Machine Corp. v. Small Business Administration*, 305 F. Supp. 2d 614, 616 (E.D. Va.), *aff'd per curiam*, 102 Fed. Appx. 352 (4th Cir. 2004). Small businesses located in HUBZones are given a ten-percent price preference when bidding against firms not located in a HUBZone. The theory behind the price preference is that, all else being equal,[38] the contracting agency would essentially favor the HUBZone firm. The HUBZone firm then would hire additional employees to service the contract, thereby enhancing economic development.

There are additional requirements for maintenance of HUBZone status. The most significant is that a firm must have at least 35 percent of its employees residing in a HUBZone. *Id.* It is important to note that the employees need not live in the HUBZone in which the business is located but can be located in any HUBZone. Presumably, increasing the number of employees with incomes will improve the overall economic development an area even if the employee does not reside in the HUBZone in which the business is located.

Contracting officers relied on the certifications and, until recently, the SBA did not check to determine whether the firm's assertion on qualification for eligibility was correct. However, after a series of investigations by the Government Accountability Office that found series flaws in the self-certification, the SBA revamped the program to include verification by agency personnel of HUBZone status. The issue of self-certification remains a primary vulnerability in the program. More significantly, if ineligible firms receive contracts as a result of incorrect status, it undermines the economic development goals of the program by denying legitimate firms federal government contracts.

Service-Disabled Veteran's Program

Congress, in 1999, amended § 15 of the Small Business Act to require the President to establish a government-wide procurement goal of not less than 3 percent for small businesses owned and controlled by service-disabled veterans. Veterans Entrepreneurship and Small Business Development Act, Pub. L. No. 106-50, 113 Stat. 233, 247 (1999). Little movement was made to increase participation by service-disabled veterans in the federal procurement process; four years later, Congress added a new § 36 to the Small Business Act with the inclusion of § 308 of the Veterans Benefits Act of 2003, Pub. L. No. 108-183, 117 Stat. 2651, 2662 (codified at 15 U.S.C. § 657f).[39] The

[38] Economists would refer to this condition as *ceteris paribus*.
[39] The bill originated with the Committee on Veterans' Affairs and the Committee on Small Business waived jurisdiction.

provision authorized but, unlike the HUBZone program, did not mandate that contracting officers set aside specific contracts for competition solely among small businesses owned by service-disabled veterans. Even after the enactment of § 36, federal agencies were not meeting the three percent goal and the President issued an executive order, E.O. No. 13,360 mandating that the heads of agencies develop strategies for implementing and achieving the goals of § 36.

Women's Procurement Program

In 2000, Congress added a new subsection (m) to § 8 of the Small Business creating a women's procurement program. Small Business Reauthorization Act of 2000, § 811, Pub. L. No. 106-554 (codified at 15 U.S.C. § 637(m)). The program authorizes, but does not mandate, that the contracting officer may set aside contracts for awards to certain women-owned businesses if the contracting officer believes that two or more such businesses will submit offers at a fair and reasonable price and the contract is for the procurement of goods of less than $5,000,000 for contracts with a manufacturing industrial classification or $3,000,000 for all other contracts. Unlike the 8(a), HUBZone, and service-disabled veterans program, there is no authority to award sole-source (non-competitive contracts).

Implementation of the program depends on the Administrator of the SBA identifying industries in which small business concerns owned and controlled by women are underrepresented in federal government procurement. The Administrator was supposed to identify these after performing a study. After five years in which the SBA did not implement the program, the SBA was sued for action unreasonably withheld, 7 U.S.C. § 706(1). The United States District Court for the District of Columbia found that the SBA unreasonably withheld implementation of the program in a 2005 decision and ordered that the SBA perform a study of historically underrepresented industries as mandated by statute, and kept jurisdiction of the case. Some five years subsequent to that court order, in late 2010, the SBA finally promulgated regulations to implement the program including the identification of women-owned businesses historically underrepresented in federal government contracting.[40]

SBA Central Contractor Registry Database Errors

The federal government maintains a database called the Central Contractor Registry or CCR. That database is used by contracting officers to identify, among other things, the businesses which are considered small.[41] Obviously, if the database is flawed, the ability

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[40] A detailed history of the administrative actions to implement this program would make this already lengthy memorandum even longer. Individuals wishing a more detailed history should contact the Chief Counsel for the Committee.

[41] Section 3(a)(1) of the Small Business Act, 15 U.S.C. § 632(a)(1), provides in pertinent part: "[a] small business concern ... shall be deemed to be one that is independently owned and operated and which is not dominant in its field of operation." The Act does not define these basic terms. The Administrator is authorized to consider the number of employees, dollar volume (including gross revenue), net income, and any other factor or combination of factors to determine what constitutes a small business for purposes of the Small Business Act or any other statute. Thus, the Administrator's determination on small business

of contracting officers to identify small businesses is severely and adversely affected. The Committee on Small Business has held a number of hearings and conducted its own investigations which uncovered significant flaws in the CCR database. Among the shocking revelations included is the fact that large businesses and not-for-profit organizations were listed as small businesses.[42] Some of these problems arise from the fact that the federal government determines the size of the small business at time of contract award and the business outgrows its appropriate size standard but the government never modifies the CCR database. In other cases, a large firm purchases a small firm that has a government contract, but the contracting officer fails to require a contract novation[43] showing the new owner of the business that has the contract, the government concurred in that assignment, and that it is no longer small. Either circumstance could lead a contracting officer to conclude that a business it awards a contract to is small even though it is not. This miscoding is particularly problematic with respect to Federal Supply Schedule[44] contracts because GSA determines that the placement on the schedule (rather than when an order is made off the schedule) constitutes the time of award. Since supply schedule contracts may last for many years or decades, it is possible that the supply schedule, used by many contracting officers, will reflect outdated size information through no fault of the contracting officer. Of course, miscoded information makes it much more difficult for the federal government to achieve the statutory goals for small business utilization set forth in § 15(a) of the Small Business Act.

Improper Subcontracting

Section 15(o) of the Small Business Act, 15 U.S.C. § 644(o), prohibits the award of a contract if the small business subcontracts more than 50 percent of the work (with exceptions that are not relevant for this memorandum) to large businesses. This policy is reflected in the FAR which requires a clause be inserted in all contracts alerting small businesses to the prohibition in section 15(o).[45] In essence, the Small Business Act and the FAR prevent a small business from acting as a front for a large business during the

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size is conclusive for purposes of federal procurement. 15 U.S.C. § 637(b)(6); *see DSE, Inc. v. United States*, 169 F.3d 21, 26 (D.C. Cir. 1999).

[42] Except with respect to agricultural cooperatives and their eligibility for disaster loans, non-profit entities are not considered small businesses for purposes of the Small Business Act.

[43] The Anti-Assignment Act, 41 U.S.C. § 15 and 31 U.S.C. § 203 prohibits the transfer of government contracts without the consent of the government. A novation is entered into to show that the federal government consented to the transfer of the government contract. *See Bonneville Power Admin. v. Mirant Corp.*, 440 F.3d 238, 252 (5th Cir. 2006); *Aerospace Components, Inc.*, 84-3 BCA (CCH) ¶ 17,536.

[44] The Federal Supply Schedule is operated by the General Services Administration. It provides federal agencies with a simplified method for obtaining commercial supplies and services at prices associated with volume discount. Federal agency contracting officers then simply look up an item listed on the schedule and obtain it from one of the suppliers that is willing to supply the item at price established by GSA. 48 C.F.R. § 8.402.

[45] The clause provides that a small business will perform at least 50 percent of the cost of the contract except in construction, including the manufacturing of supplies. For general construction, small businesses must perform 15 percent of the cost (exclusive of materials) and specialty trade construction, 25 percent. 48 C.F.R. § 52.219-14. The clause only applies if the contract is awarded to a small business through a procedure other than full and open competition, i.e., one of the set-aside programs established in the Small Business Act.

bid phase,[46] or can result in contract termination if the violation is discovered after the contract award.[47] Despite these potential penalties, violations of the subcontracting limitations continue unabated. If the purpose of small business contracting programs is to ensure that small businesses are the ultimate recipients of the economic benefits from the award of contracts, then this practice of improper subcontracting, also colloquially referred to as pass-throughs, undermines the Congressional rationale for the creation of the programs in the first instance.

Most small government contractors would recognize their inability to produce certain items needed by the federal government. Typical examples are usually taken from large weapon systems needed by the military, such as aircraft carriers or fighter jets. Despite their inability to produce such items, Congress recognized that small businesses still might make valuable contributions to the overall development and mandated that small businesses have maximum opportunity to participate in contracts for major systems. 15 U.S.C. § 637(d)(1).

To implement this objective, Congress requires large firms that are awarded contracts to submit a subcontracting plan. *Id.* at § 637(d)(5)(A)(iv). The plans must contain, among other things, the efforts that the contractor will take in ensuring proper small business utilization as well as numeric goals for use of small business as subcontractors. *Id.* at § 637(d)(6). Prime contractors are required to make a good faith effort to comply with the subcontracting plans. *Id.* at § 637(d)(8). Failure to make a good faith effort to comply with the subcontracting plan will subject the contractor to liquidated damages.[48] *Id.* at § 637(d)(4)(F).

The SBA is required to assist agencies in ensuring that small businesses have maximum opportunities to offer goods and services as subcontractors. 15 U.S.C. § 637(d)(10). To carry out this mission, SBA personnel are directed to review compliance with subcontracting plans. *Id.* at § 637(d)(10)(C). However, neither the FAR[49] nor the SBA regulations specify what decisional calculus should be used by the contracting officer or SBA personnel in assessing good faith compliance with the subcontracting plan. Given this lack of criteria, it is not surprising that the federal government has never sought, much less obtained, either liquidated damages or termination for default related to the failure to make a good faith effort to comply with federal subcontracting plans.

[46] The failure of a small business to agree to perform the required amount of work constitutes a non-responsive bid. *See Centech Group, Inc. v. United States*, 554 F.3d 1029, 1038 (Fed. Cir. 2009).
[47] *In re: Barton Chemical Corp.*, 87-1 BCA (CCH) ¶ 19,623 (violation of subcontracting limitation material breach of contract).
[48] Liquidated damages refers to "the sum a party to a contract agrees to pay if he breaks some promise, and which, having been arrived at by a good faith effort to estimate in advance the actual damage that will probably ensue from the breach, is legally recoverable . . . if the breach occurs." *Pantuso Motors, Inc. v. CoreStates Bank, N.A.*, 798 A.2d 1277, 1282 (Pa. 2002) (quoting citations omitted). In the case of failure to comply with the subcontracting plan, the liquidated damages are specified in the FAR as the "amount equal to the actual dollar amount by which the contractor failed to achieve each subcontracting goal." 48 C.F.R. § 19.705-7(b). The procedures to obtain liquidated damages are set out in the FAR. *Id.* at § 19.705-7(c).
[49] The FAR simply orders the contracting officer to "look at the totality of the contractor's actions, consistent with the information and assurances provided in its plan." *Id.* at § 19.705-7(d).

Government Contracting Programs and FY 2012 Budget

There are two primary expenses involved the SBA operation of its government contracting programs – salaries for personnel and information technology resources. The FY 2012 Budget requests an increase of about $5 million from FY 2010 levels. Most of the increase is associated with personnel and information technology associated with rooting out fraud and vulnerabilities in the SBA contracting programs. However, it is not clear whether the budget request will be directed to resolve the vulnerabilities already identified or whether the SBA will succeed in removing the problems that exist in its government contracting programs.

A more serious problem is that the funds requested may be misdirected as well. While fraud and abuse in the programs must be rooted out, there is an equally important mission for the SBA – to promote the use of small businesses in federal government contracting. However that requires the correct personnel to work with small businesses and federal agencies in order to develop procurement strategies that will utilize small businesses.

The SBA has three types of individuals devoted to ensuring that small businesses have maximum opportunities to provide goods and services to the federal government. They are procurement center representatives (PCRs), breakout procurement center representatives, and commercial marketing representatives (CMRs).

PCRs generally are assigned to contracting activities and work under the supervision of the contracting activity personnel (but report to the Office of Government Contracting at the SBA). 48 C.F.R. § 19.402(a)(1). They are supposed to: 1) review proposed acquisitions to recommend procurements for setting aside to small businesses or specific categories of small businesses; 2) advise contracting officers whether the acquisition strategy will prevent small businesses from competing; 3) suggest alternative contracting methodologies designed to increase the probability small businesses will be able to compete for various procurements; 4) recommend small businesses that should be contacted about procurement solicitations; 5) appeal rejections of contracting officer's failure to solicit from a small business if the failure results in no small businesses are solicited for a particular contract; 6) review contracting activity compliance with the requirements of Part 19 of the FAR;[50] and 7) participate in conferences designed to increase small business utilization in federal procurement. *Id.* at § 19.402(c).

Breakout PCRs must be assigned to major procurement activities.[51] *Id.* at § 19.403(a). These individuals do not replace regular PCRs but work in conjunction with them. *Id.* The breakout PCRs advocate for: 1) use of full and open competition; and 2) the breakout (ergo the name) of items from contracts that could be provided by small businesses. *Id.*

[50] Part 19 of the FAR incorporates the policies designed to promote the utilization of small businesses in federal procurement activities.

[51] Major procurement activities are places where the federal government purchases substantial dollar amounts of goods or services other than commercial off-the-shelf items. *Id.* at § 19.403(a).

In essence, the breakout PCR is the primary bulwark for the SBA against bundling of contracts[52] by major federal procurement activities.[53] There are far fewer breakout center PCRs than PCRs, thus significantly limiting the ability of the SBA to fight contract bundling.

CMRs promote the use of small businesses by prime federal contractors required to submit subcontracting plans, i.e., businesses other than small. They review compliance with federal subcontracting plans. In addition, they perform market outreach to match small businesses and large prime federal contractors.[54] As GAO noted, personnel assigned CMR responsibilities perform those in addition to other functions assigned to them by the SBA.[55]

PCRs and CMRs play a vital role in helping small businesses obtain federal procurement opportunities. The number of such individuals at the SBA is well short of their need. Absent sufficient personnel, the SBA will be unable to meet the Congressional mandate that small businesses receive their fair proportion of the total purchases and contracts for property and services for the Government in each industry category. Despite this evident need, the budget allocates resources to such amorphous items as creation of regional innovation clusters, "Executive Direction," or the implementation of the President's Interagency Task Force on Small Business Contracting than providing boots-on-the-ground personnel who can help small businesses grow by helping develop pro-small business procurement strategies at large federal purchasing facilities.

Entrepreneurial Assistance and Outreach Programs

The SBA oversees the operation of a multiplicity of programs that provide technical assistance to individuals wishing to start small businesses and to already extant small businesses. Collectively, these programs are categorized by the as entrepreneurial development or ED programs. The programs range from narrowly targeted programs to very broad programs that take advantage of the resources of America's higher education system and retired business executives. The programs all have one commonality – the SBA shares funding or staffing or a combination of both with non-profit organizations, other federal agencies, and state or local governments. Other than some personnel to oversee the operations of these programs, the primary cost of the programs is the monies appropriated to fund the SBA portion of these outreach efforts.

Small Business Development Centers

The largest ED program in terms of facilities and outreach is the Small Business Development Center (SBDC) program. Basically, the SBDC program is a cooperative

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[52] Bundling of contracts is a procurement strategy in which the requirements of the contract could not be met by small businesses. A detailed explication of bundling is beyond the scope of this memorandum but it remains the most significant barrier to federal procurement by small businesses.
[53] For detailed responsibilities of breakout PCRs, see *id.* at § 19.403(c)(1-10).
[54] GENERAL ACCOUNTING OFFICE, THE COMMERCIAL MARKETING REPRESENTATIVE ROLE NEEDS TO BE STRATEGICALLY PLANNED AND ASSESSED 3-4 (GAO-03-54) (Nov. 2002).
[55] *Id.* at 9-11.

program grant between selected state agencies (or institutions of higher education)[56] and the SBA to operate centers where prospective entrepreneurs and existing small business owners can go to obtain assistance.[57] The assistance is provided at no cost to the business. This enables the entrepreneurs to take advantage of the skills and expertise of higher education faculty and students to provide assistance.

Funds are provided pursuant to a complex formula related to the percentage of population of each state relative to the national population. The formula is further complicated by requiring minimum amounts of grants and those minima are calculated from a statutory baseline of $85,000,000 in funding for the program. Funds provided by the federal government must be matched by the SBDC grantee from non-federal sources, such as private donations or state funds.

For FY 2012 Budget, the request for SBDC funding is $103 million – a reduction of more than $9 million from FY 2010/11. In some respects this reduction has both benefits and costs. Obviously, this reduces the federal share of funds that are available for SBDC grantees to provide assistance to small businesses. However, given that many grantees are state agencies or public university systems, the reduction in funding also means that financially pressed states will not need to raise as much in matching funds.

Women's Business Centers

Women's Business Centers (WBCs) provide training, counseling, and mentoring to women entrepreneurs. WBCs are required to focus on the needs of socially and economically disadvantaged women. Originally, the WBCs were established in 1991 as a three-year pilot program. In 1997, Congress kept the basic premise of the demonstration projects but redesignated the names to Women's Business Centers, extended the time frame for the demonstration projects to five years, modified the matching contributions, and imposed review requirements to ensure that Women's Business Centers were meeting the obligations of their grants. The intent of Congress in 1997 was to provide a limited amount of government funding until the centers were sufficiently established that they could operate solely on the basis of private funds.

Two years later, Congress reacted to complaints that these centers could not raise funds during the end of the telecommunications and Internet bubbles. Congress created a pilot

[56] When the program was started in 1980, the grantees either could be state agencies or institutions of higher education. Congress later changed the program only allowing institutions of higher education to be grantees but grandfathering in existing state agency grantees. To complicate matters, state agencies that are grantees often subcontract the provision of services to institutions of higher education. For example, the grantee for the State of Illinois is the Department of Trade but the services are provided by community colleges throughout Illinois. Finally, neither the SBA nor the section of the Small Business Act creating the program makes a proper distinction between the grantees and the service centers where small businesses are assisted. Both are interchangeably and incorrectly called SBDCs.

[57] The assistance provided by the grantee through its SBDC network is specified in statute and is quite broad to include: business analysts; technology transfer agents; information retrieval specialists; various part-time professionals who donate time, such as lawyers and professional engineers; and laboratories and engineering facilities. SBDCs have the authority to utilize federal national laboratories. They also have the authority and ability to provide small businesses with advice about energy efficient technologies.

program[58] to provide some of the centers with so-called sustainability funds. Initially, sustainability funds represented about one-third of the total funds appropriated for establishment of WBCs. Today, approximately 50 percent of the funds appropriated are to go to existing centers operating through the sustainability pilot program (which really is no longer a pilot program) and little effort is made to force the centers to seek more non-federal funding. If the government always appropriated around $14 million (the typical appropriation for the program), new centers would be created as old centers passed their five-year anniversary and lost their federal funding. However, since the creation of the sustainability pilot project and the ever-increasing funds devoted to funding existing centers past their five-year anniversary, far fewer new centers can be established even if the population of potential women entrepreneurs is not coextensive with the geographic area served by the existing centers.

The FY 2012 request for WBCs $14 million dollars which is the roughly the same amount as provided in FY 2010. An open question exists concerning whether the services provided by WBCs overlap and duplicate services provided by other extant ED program partners of the SBA or are available from other federal agencies. This issue is particularly relevant since WBCs were not originally intended to exist as permanent recipients of federal funds.

SCORE

The SBA provides office space to a corps of executives from both large and small businesses. These executives volunteer their time to provide assistance to entrepreneurs. Such assistance can be as simple as suggesting that a business owner contact the SBA to as much as helping them draft business or marketing plans. The scope of the service provided by the volunteers really depends on their interest and the relationship that develops between the volunteers and the business owners seeking counseling. Although originally known as the Service Corps of Retired Executives, the program is now known as SCORE because many of the contributing executives are active rather than retired. The FY 2012 request for SCORE is the same as it was in 2010 – $7 million (this has been the appropriation for a number of years now). This monetary assistance primarily relates to the SBA's costs for providing office space, telephones, Internet access and other ancillary services to the volunteers.

Veterans Business Development

The SBA has an Associate Administrator for Veteran's Affairs that oversees the Office of Veterans Business Development. The Office provides services to maximize the availability, applicability and utility of all programs offered by the SBA to veterans and service-disabled veterans, and reservists. The Office has Veterans Business Development Officers in each SBA district office to prepare and plan businesses operated by veterans.

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[58] The sustainability pilot was designed to last only four years, i.e., to 2003. But the pilot program, has through authorizing language on appropriations bills, become something more permanent with the expectation that sustainability funds will always be available.

Veterans Business Development Officers are SBA employees that have special expertise in addressing the needs of veterans.

Through cooperative agreements with non-profit entities, the Office manages a Veterans Business Outreach Centers (VBOCs). The program operates in a manner almost identical to that of the SBDCs and WBCs, i.e., the SBA provides funds and the non-profit entities raise matching funds. The scope of services provided to veterans is identical to the services provided to all entrepreneurs by SBDCs and WBCs.

The FY 2012 Budget request to fund Veterans Outreach is $2.5 million – the same as in FY 2010. This request primarily covers the operation of the VBOCs. Funds for employees located at SBA district offices are subsumed in the salary and expenses account for the agency.

Native American Outreach

The Office of Native American Affairs ensures that American Indians, Native Alaskans and Native Hawaiians seeking to create, develop and expand small businesses have full access to the necessary business development and expansion tools available through the SBA's entrepreneurial development, lending and procurement programs. The Office engages in numerous outreach activities including tribal consultations, development and distribution of promotional materials, attendance and participation in national economic development conferences. There are no separate outreach offices, such as VBOCs or Women's Business Centers, for outreach to Native Americans. Funding for Native American outreach remains unchanged from FY 2010 at approximately $1.25 million.

Office of International Trade

The Office of International Trade provides assistance to businesses involved in export or import business.[59] The major component is the placement of SBA personnel at United States Export Assistance Centers operated by the Department of Commerce. The Small Business Jobs Act of 2010 mandated that the Office increase the number of SBA personnel from 18 to 30 at the Export Assistance Centers as well as some other managerial changes. The FY 2012 Budget request for the Office of International Trade is approximately the same as in FY 2010 at around $8.2 million.

<u>ED Programs and the FY 2012 Budget</u>

As can be seen from the details, the SBA has a panoply of entrepreneurial training programs that overlap by providing identical services often to overlapping small business populations. Almost nothing in the FY 2012 Budget recognizes this duplication of services and the need to rationalize the offering of technical assistance to small businesses. To the extent that these programs are duplicative, they draw resources away from other critical needs of the agency, such as overhauling the LMAS to improve

[59] There are specialized 7(a) guaranteed loans for businesses involved in international trade. Less than 10 percent of the loans made under the 7(a) Loan Program are these specialized international trade loans.

management of its loan portfolio or hiring PCRs to help small businesses obtain federal contracts.

New Initiatives in the FY 2012 Budget

There are a number of new initiatives that the SBA wants to implement. One is a new lending initiative authorized by the Small Business Jobs Act of 2010; the others are agency-designed programs. All have one common element – the data supporting the need for these initiatives are not evident in hearings held by Congress or in the submission by the SBA to Congress.

Small Business Intermediary Lending Pilot Program

The provision arises from the Senate version of the Small Business Jobs Act of 2010. No separate Senate report exists to explain the rationale for this program. Debate on the Senate floor did not even include so much as colloquy about this provision. Under the program, 20 intermediaries will be loaned $1,000,000 each to make loans of up to $200,000 to small businesses. The intermediaries will not have to repay these $1,000,000 loans for a period of two years (either principal or interest) and then the interest rate is one percent. In short, this program could wind up making loans to exactly 100 businesses (each intermediary making $200,000 loans to five businesses). According to Congress the purpose of the program is to alleviate the lack of credit availability to small businesses. Considering that there are about 28 million small businesses, this program could be limited to a total of less than three-ten thousandths of one percent of the small businesses in the United States. And according to the President's budget, the subsidy rate for this program is almost 30 percent. In contrast, the 7(a) Loan Program subsidy rate is less than one percent. Thus, the program helps very few businesses at a high risk to the government treasury.

Regional Innovation Clusters

A "cluster" refers to a geographically confined collection of related firms.[60] Although most commonly known in this country in relation to high-tech areas the biotechnology firms along Interstate 270 in Montgomery County, Maryland or Silicon Valley in California, clusters are not restricted to high technology firms.[61]

The development of innovative clusters occurs through something of a feedback loop. For example, a cluster requiring advanced educational training is more likely to locate near universities, such as the Research Triangle Park in North Carolina, than in other areas of the country.[62] Once some firms begin to locate in an area, others (given the

[60] Luger, *Smart Place for Smart People: Cluster-Based Planning in the 21st Century Knowledge Economy*, *in* ECONOMIC DEVELOPMENT THROUGH ENTREPRENEURSHIP: GOVERNMENT, UNIVERSITY AND BUSINESS LINKAGES 154 (S. Shane ed. 2005).
[61] M. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 155-56, 190, 213 (1989).
[62] Luger, *Smart Place for Smart People: Cluster-Based Planning in the 21st Century Knowledge Economy*, *in* ECONOMIC DEVELOPMENT THROUGH ENTREPRENEURSHIP: GOVERNMENT, UNIVERSITY AND BUSINESS LINKAGES 161 (S. Shane ed. 2005).

utility of geographic proximity)[63] will follow. The cluster will sprout and mushroom, usually through the activity of other entrepreneurs.[64] Due to the independent mentality of entrepreneurs, it is difficult for governments to take planning actions that actively create clusters.[65]

Instead of directly creating clusters, the SBA's Regional Innovative Cluster program awards grants to non-federal entities that in turn would help create clusters. The SBA is asking for $12 million for FY 2012 to expand its existing cluster program. Nothing in the SBA's request demonstrates how many jobs were created, whether those clusters would have formed without any assistance, or whether the clusters will continue to exist. Given this, it is unclear whether $12 million should be spent on the Regional Innovative Clusters Program.

Emerging Leaders Program

This program started in FY 2009 provides training to executives in inner city urban areas and Native American entrepreneurs. Businesses are selected based on growth and the small business executives are provided with 8 months of intensive training.[66] The program originated without any funding; yet over 600 small businesses participated according to the agency. Even though there is no hard data on the success of the program (the data is self-reported by the businesses that went through the program) and the SBA was able to conduct the program without appropriated funds, the SBA is seeking $3 million for this program in FY 2012.

Executive Direction

The budget for Executive Direction, a conglomeration of various offices associated with policy and research has steadily increased since FY 2009. In fact, it has gone up almost $10 million even though the offices funded under Executive Direction have not seen any increase in their budgets. The biggest change is in the costs for operating the Office of Advocacy.[67] The budget for the Office according to Table 1 of the Budget Submission, including operating expenses, research and personnel is $9 million. The agency then estimates in Table 9 of the same document that the cost for running the Office of Advocacy including overhead and indirect costs is $19 million. However, the overhead cost for running the entire SBA is about $56 million (Table 3 of the Budget Submission).

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[63] M. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 152-65 (1989).

[64] Feldman, Francis & Bercovitz, *Creating a Cluster while Building a Firm: Entrepreneurs and the Formation of Industrial Clusters*, at 131.

[65] Luger, *Smart Place for Smart People: Cluster-Based Planning in the 21st Century Knowledge Economy*, *in* ECONOMIC DEVELOPMENT THROUGH ENTREPRENEURSHIP: GOVERNMENT, UNIVERSITY AND BUSINESS LINKAGES 164, 180 (S. Shane ed. 2005).

[66] In this regard, the program mirrors the "7(j) Program" (named after § 7(j) of the Small Business Act) that provides management training to participants in the 8(a) government contracting program. Nothing in the description of the Emerging Leaders Program would prevent an executive from participating in that program as well as the 7(j) training program.

[67] The Office of Advocacy is headed by a Chief Counsel and is independent of the SBA. The Chief Counsel monitors agency regulations to assess the impact such rules will have on small businesses. The Office has 46 full-time employees and is located on part of a floor of the SBA headquarters.

It is very hard to believe that a small office within the SBA can account for approximately 17 percent of the SBA's entire overhead costs (considering nearly 60 percent of the overhead is for leasing office space for 84 district offices). There remains no explanation for this sudden increase in Executive Direction and the funds either should be eliminated or reallocated to better use (such as improving the LMAS).