

This is a commercial communication from Hogan Lovells. See note below.

SBIC Program Updates: SBA Proposes Technical Amendments to 2023 Reforms and Significant Change to Passive Business Rule

In July 2023, the U.S. Small Business Administration (SBA) released sweeping reforms to the Small Business Investment Company (SBIC) program. Many of those reforms were enacted through the *Small Business Investment Company Investment Diversification and Growth final rule* effective on August 17, 2023 (SBIC IDG Final Rule), which reduced barriers to program participation for new SBIC fund managers and funds investing in underserved communities and geographies, capital intensive investments, and technologies critical to national security and economic development.

On January 19, 2024, SBA released a [direct final rule](#) (referred to below as the “Proposed Rule”), which clarifies and provides technical updates to the earlier SBIC IDG Final Rule. This rule is slated to come into effect on March 4, 2024, without further action, unless significant comment is received by February 20, 2024.

The Proposed Rule introduces a series of technical amendments and clarifying updates. These include, but are not limited to, the following key areas, which will be discussed in greater detail in this client alert:

- reducing structural challenges for SBICs investing in portfolio companies through holding companies and other passive entities;
- modifying the requirements for subsequent SBIC applicants to participate in the expedited filing process;
- resolving previous inconsistencies regarding “overline” limitation calculations;
- clarifying rules for distributions and repayment of SBA leverage and fees for Accrual Debentures;
- clarifying filing requirements for reinvestor SBICs; and
- implementing various other technical corrections.

Financing of Passive Business

The most significant change for most currently licensed SBICs is a revision to the rule on financing passive business, which currently limits the ability of SBICs to invest in companies through holding companies, blockers and other similar structures. Current SBIC regulations allow SBICs to structure investments with up to two tiers of passive entities as long as substantially all of the financing proceeds are passed through to, or used to acquire, one or more active operating companies, and each active operating company is an eligible small business.¹ While the current regulations offer SBICs some limited flexibility when structuring their investments, it presents a challenge as deal structures often include three or more tiers of passive entities.

In a change SBA believes will provide additional flexibility on investment structuring and increase flow of capital in the SBIC program, the Proposed Rule purports to allow SBICs to structure investments with an unlimited

¹ 13 CFR 107.720(b)(2)

numbers of tiers of passive entities as long as substantially all proceeds from the financing are passed through to the eligible small business.² SBA also indicated in the Proposed Rule’s preamble that each passive entity in the structure will be subject to the same SBA size standards and reporting requirements as the eligible small business and that SBA will maintain enforcement rights against each small business that is financed (which will likely apply only if SBA were appointed as receiver of an SBIC). In order to be fully effective, this proposal by SBA may require further regulatory language adjustments. Once that has been determined, we will update this guidance as appropriate.

The Proposed Rule also clarifies that 13 CFR 107.720(b)(3) allows SBIC business development companies (BDCs), as recognized under the U.S. Investment Company Act of 1940, as amended from time to time (the Company Act) to form blocker entities to avoid adverse tax consequences that could jeopardize the BDC’s qualification as a registered investment company under the Company Act.

Subsequent Fund License Applicants

The SBIC IDG Final Rule created an expedited SBIC license application process for subsequent fund SBIC applicants in the event that such applicants can meet 11 eligibility criteria.³ While the criteria are strict, the new process provides a meaningful benefit in the form of an expedited licensing process.

One of the key criteria relates to “limited partnership (LP)-general partnership (GP) dynamics.” The SBIC IDG Final Rule requires that, among other things, “the two largest investors in terms of committed capital [in the prior SBIC] have verbally committed to invest in the new fund pending receipt of license.” The Proposed Rule replaces this language to provide instead that “SBA would expect to see that a meaningful proportion of a prior SBIC fund’s institutional investor base would return to support an anticipated subsequent SBIC fund.”⁴ This change creates additional flexibility for subsequent fund applicants to demonstrate the consistent LP-GP dynamics by not requiring them to strictly meet a two-largest investors test. SBA has not provided guidance on what constitutes a “meaningful portion,” but we expect that standards will emerge in practice.

Overline/Portfolio Diversification

SBICs are subject to a concentration limit known as the “overline” limitation. The regulatory formula used to calculate an SBIC’s “overline” limitation in 13 CFR 107.740 is inconsistent with the statutory formulation with respect to calculation of a Licensee’s “overline” limitation. For example, the regulations indicate that if an SBIC has two tiers of SBA leverage, then the SBIC’s overline would be equal to three times such SBICs “regulatory capital.” Meanwhile, the statute indicates that an SBIC’s overline is equal to 10% of total approved SBA leverage plus “regulatory capital.”⁵ As a result, if an SBIC is not leveraged with a ratio of exactly 2:1, then the overline limitation under the current regulations and the statute are inconsistent, potentially leading to unintentional foot-faults by SBICs. The Proposed Rule updates the language in the regulations to align with the statutory overline formulas.

It is important for licensed SBICs to note that in connection with this change, SBA also removed the “add back” of approved reductions of “regulatory capital” to the regulatory formula described in the regulations.⁷ As a result, an SBIC’s overline limit can be reduced over the life of the SBIC as, for example, it makes distributions to investors following a successful exit transaction. In addition, the Proposed Rule deletes the language that states the overline limitation must take into account the original cost of any financing including amounts that have been written

² *Proposed* 13 CFR 107.720(b)(2).

³ 13 CFR 107.305(e).

⁴ *Proposed* 13 CFR 107.305(e)(1)(i).

⁵ Small Business Investment Act of 1958 (the “SBIC Act”), Section 306(a)

⁶ Notably the SBIC Act uses the defined term “Private Capital” but it is substantially similar to the definition of “Regulatory Capital” used in the regulations promulgated thereunder. *Proposed* 13 CFR 107.740 uses the term “Private Capital” under the SBIC regulations which is a broader term and includes Regulatory Capital *plus* certain noncash assets of the SBIC, such as the fair market value of services contributed to the licensee.

⁷ 13 CFR 107.740(a)(2)-(3) currently includes this “add back” provision which is absent from *Proposed* 13 CFR 107.740.

off.⁸ One possible interpretation of this change is that SBICs that write off a portion of their investment may be permitted to *increase* the total investment to a particular portfolio company because the portion that was written off is no longer included in the overline limitation.

Revised Accrual Debenture Repayment Mechanics

- a. **Timing of certain payments to SBA.** One of the most substantial additions in the SBIC IDG Final Rule was the creation of the new Accrual Debenture as well as the Accrual SBIC and Reinvestor SBIC, both of which rely on the Accrual Debenture.⁹ A related change was the promulgation of 13 CFR 107.585(c), which sets forth the rules governing distributions and repayment of Leverage for Accrual Debentures. The Proposed Rule provides revised language regarding the timing of non-tax distributions and, in particular, clarifies that payments to SBA of Annual Charges and accrued interest on outstanding Leverage must be paid on or before the date that distributions are made to private investors.¹⁰ Under the current rules, there is a six-month payment window following distributions to private investors during which such payments to SBA must be made.¹¹ The Proposed Rule eliminates this six-month payment window.¹²
- b. **Calculation of leverage available.** To determine the total Accrual Debentures that Accrual SBICs and Reinvestors SBICs may issue, the preamble to the SBIC IDG Final Rule specifies that SBA will aggregate (i) the total principal leverage *plus* (ii) ten years of accrued interest on such principal, and this total is limited by the statutory maximum.¹³ While the Proposed Rule does not include changes to this section of the regulations, the Proposed Rule’s introductory language and section analysis state that with respect to this section of the SBIC regulations, “SBA seeks to clarify that this aggregation is based on an estimate of potential interest which could accrue based on prevailing interest rates at the time of licensing.”¹⁴

Since SBA will perform this “forecasting exercise” to determine the Total Intended Leverage Commitment conditionally approved as part of the Green Light approval – and to ensure SBA “safely manages the risk of an outsized interest balance accruing.” The Proposed Rule additionally specifies that the terms of the Accrual Debenture will require SBICs to issue prompt payment of any interest that has accrued in excess of the limitation of SBA Leverage available (currently \$175 million) at the end of each quarter.

Reinvestor SBIC Reporting, Permitted Investments, and Affiliate Clarifications

- a. **Revised Reporting Timelines.** SBICs are required to file annual and interim financial reports on SBA Form 468 within 90 calendar days of the end of the SBIC’s fiscal year or reporting period and quarterly financial reports within 45 days after the close of the quarter.¹⁵ The Proposed Rule, via revisions to 13 CFR 107.630 and 13 CFR 107.650, grants additional time for Reinvestor SBICs to file SBA Form 468. Specifically the Proposed Rule permits Reinvestor SBICs to file annual and interim reports to within 120 calendar days of the end of the SBIC’s fiscal year or reporting period.¹⁶ All other SBICs must continue to file SBA Form 468 annually within 90 calendar days of the end of the SBIC’s fiscal year.¹⁷ All leveraged SBICs continue to be required to file SBA Form 468 (Short Form) within 45 days after the close of the quarter.¹⁸

⁸ 13 CFR 107.740(a) currently includes this language which is absent from *Proposed Rule* 13 CFR 107.740.

⁹ 13 CFR 107.50.

¹⁰ *Proposed* 13 CFR 107.585(c)(1) and (2).

¹¹ 13 CFR 107.585(c)(1).

¹² *Proposed* 13 CFR 107.585(c)(1) and (2).

¹³ 13 CFR 107.1150.

¹⁴ SBIC IDG Final Rule Supplementary Information §II(L).

¹⁵ 13 CFR 107.630(a) and 13 CFR 107.1220.

¹⁶ *Proposed* 13 CFR 107.630(a).

¹⁷ 13 CFR 107.630(a).

¹⁸ Notably, the Proposed Rule does not provide for a corresponding revision to the quarterly financial reporting requirements under 13 CFR 107.1220 for Reinvestor SBICs. Therefore Reinvestor SBICs remain required to file SBA Form 468 (Short Form) within 45 days after the close of the first three quarters of the fiscal year.

- b. **Permitted Investments.** The SBIC IDG Final Rule only refers to “Equity Capital Investments” when permitting Reinvestor SBICs to make investments in certain underlying business engaged in the business of making loans or equity investments, as an exception to the general prohibition on SBIC investments in such companies.¹⁹ The Proposed Rule clarifies that Reinvestor SBICs may (i) make “equity capital investments” to “disadvantaged businesses” that are relenders or reinvestors, including Community Development Financial Institutions (CDFIs) and Minority Deposit Institutions (MDIs) and (ii) provide long-term debt or loan financing to CDFIs and MDIs.²⁰ It is important to note, however, that many CDFIs are non-profit entities, and the Proposed Rule does not create an exception to the general rule that an SBIC is permitted to invest only in for-profit businesses.
- c. **Affiliate Status.** While the SBIC IDG Final Rule addresses affiliate status as between Reinvestor SBICs and the Small Businesses in which they directly invest (i.e., the underlying funds), it does not discuss the affiliate relationship between the underlying fund and the Small Businesses in which the underlying fund reinvests.²¹ The Proposed Rule addresses this question and modifies the definition of Affiliate at 13 CFR 121.103(b)(1) to clarify that an underlying fund is not affiliated with the qualifying Small Business in which the underlying fund reinvests.

Additional updates

In addition to the key provisions previously discussed, the Proposed Rule includes several other noteworthy changes to the relevant SBIC regulations:

- a. **Annual Charge:** SBA has revised Section 107.1130 to specify that the annual charge is calculated based on the principal amount of outstanding debentures, eliminating an ambiguity created by using the term “Leverage” in the current regulations which could have included both principal and interest.²²
- b. **Fund-of-funds Investors:** The definition of “Institutional Investor” as updated removes includes entities that are also registered investment advisers (RIAs) regulated by the U.S. Securities and Exchange Commission, provided the relevant SBIC’s Limited Partnership Agreement (LPA) contains adequate provisions to ensure collectability.²³ Although not explicitly outlined in the Proposed Rule, the preamble indicates this change is aimed at eliminating the necessity for dual commitments or backup letters, for fund-of-funds investors. While the Proposed Rule does not provide detail about the required LPA language, SBA’s SOP states that the current language in SBA’s model LPA Sections 5.09 through 5.15 (the default provisions) is sufficient.
- c. **Ownership of SBICs by Non-Profit Entities:** Currently, no more than 70% of a leveraged SBIC’s regulatory capital may be owned by a single person or affiliated group, with an exception for ownership by “traditional investment companies.”²⁴ The Proposed Rule expands this exception by also allowing non-profit entities to own more than 70% of regulatory capital.²⁵
- d. **Investments by Government Entities:** The current rule prohibits SBICs from accepting funds from any state or local government entity if those funds exceed 33% of an SBIC’s regulatory capital.²⁶ The Proposed Rule allows SBICs to accept unlimited investments from local, state, and federal government sources, though the amount of these non-private funds that can be counted toward an SBIC’s “regulatory capital” continues to be capped at no more than 33% of an SBIC’s total regulatory capital, and the prohibition against government control remains in effect.²⁷ The Proposed Rule, however, permits an SBIC to include all funds contributed by government entities in its management fee calculation.

19 13 CFR 107.720(a)(2)(i).

20 Proposed 13 CFR 107.720(a)(2)(i).

21 13 CFR 121.103(b)(1).

22 Proposed 13 CFR 107.1130.

23 Proposed 13 CFR 107.50.

24 13 CFR 107.150.

25 Proposed 13 CFR 107.150.

26 13 CFR 107.230(d)(3).

27 Proposed 13 CFR 107.230(f).

- e. **Applicant Track Record:** The Proposed Rule clarifies that an applicant’s track record, submitted as part of the license application process, does not have to be a “certified” track record.²⁸ This is consistent with SBA’s past practice.
- f. **Additional Technical Revisions:** SBA has enacted a series of additional technical clean-up changes to 13 CFR 107.50, 107.1120, 107.1850, and 107.855.

Conclusion

While some additional clarifications may be needed, we believe that overall the Proposed Rule provides helpful clarifications to the SBIC IDG Final Rule. We will continue to monitor SBA communications and regulatory changes.

We will make ourselves available to answer any questions that you have. If you do have questions, please feel free to reach out to any member of the Hogan Lovells SBIC team.

²⁸ Proposed 13 CFR 107.305.

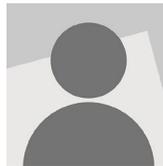
Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta *
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.

*Our associated offices
Legal Services Centre:
Berlin

Contributors



David A. Winter
Partner, Washington, D.C.
T +1 202 637 6511
david.winter@hoganlovells.com



Carol Fendler
Independent Regulatory
Consultant, Washington, D.C.
carol.fendler@hoganlovells.com



Madelyn Healy Joseph
Counsel, Washington, D.C.
T +1 202 637 3667
madelyn.healy@hoganlovells.com



Kevin Lees
Corporate Funds Area Operations
Manager, Washington, D.C.
T +1 202 637 5432
kevin.lees@hoganlovells.com



Myles DePass
Senior Associate, Washington, D.C.
T +1 202 637 5522
myles.depass@hoganlovells.com



Rachel Bayer
Associate, New York
T +1 212 918 3811
rachel.bayer@hoganlovells.com



Madison Kirton
Associate, New York
T +1 212 918 3788
madison.kirton@hoganlovells.com



Justin Bevilacqua
Associate, Washington, D.C.
T +1 202 637 3231
justin.bevilacqua@hoganlovells.com

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.

The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.

For more information about Hogan Lovells, the partners and their qualifications, see www.hoganlovells.com.

Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.

© Hogan Lovells 2024. All rights reserved.