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REPORT TO THE CONGRESS

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BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

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A Look At How The Small Business Administration's Investment Company Program For Assisting Disadvantaged Businessmen Is Working

These investment companies and the small businesses they finance have experienced problems during the early years of the program's operation. Whether the small businesses become viable depends to a large measure on the practices of the investment companies. Since these practices can promote or hinder the interests of small businesses, they should be carefully watched by the Small Business Administration as the advocate of small businesses.

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OCT. 8, 1975



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This is the second in a series of reports to be issued pursuant to Public Law 93-386, which requires us to conduct a full-scale audit of the Small Business Administration. This report discusses the improvements needed in the 301(d) small business investment company program.

We are sending copies of this report to the Director, Office of Management and Budget, and the Administrator, Small Business Administration.

A handwritten signature in black ink, reading "Thomas A. Staats".

Comptroller General
of the United States

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ABBREVIATIONS

GAO General Accounting Office

MESBIC minority enterprise small business investment
 company

SBA Small Business Administration

SBIC small business investment company

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

A LOOK AT HOW THE SMALL
BUSINESS ADMINISTRATION'S
INVESTMENT COMPANY PROGRAM
FOR ASSISTING DISADVANTAGED
BUSINESSMEN IS WORKING

D I G E S T

The Small Business Administration licenses, regulates, and, in part, finances privately owned and operated investment companies whose purpose is to provide equity capital, long-term loans, and management assistance to small businesses that are at least 50 percent owned and managed by socially or economically disadvantaged businessmen.

It does so under section 301(d) of the Small Business Investment Act.

Although the program is just getting into high gear, patterns have emerged which warrant actions by the agency:

- Available funds are being only partially invested. (See p. 4.)
- For those businesses receiving help, the investment companies are opting for loans rather than more risky equity participation. (See p. 7.)
- Granted the risks assumed by the investment companies, some of their arrangements with small businesses appear to be one sided. (See p. 9.)
- Eligibility requirements were poorly defined, and help was being given to some businesses that did not appear to need assistance. (See p. 12.)
- Better management information could result if improvements were made in the reporting system for monitoring 301(d) investment company activities. (See p. 14.)

--The Small Business Administration has essentially adopted a hands-off approach to the program, preferring what it terms "the capitalistic way."

As the advocate of the small businessman, the Small Business Administration needs to be more directly concerned with the practices of these companies in their continuing effort of providing equity financing.

GAO's findings were brought to the attention of the Administrator. He has agreed to take action on (1) apparent ineligibility of business applicants and eligibility guidance, (2) the contingency of management fees based on profits, and (3) the reporting system to provide better management information.

Other than those matters, he believes that the Administration is doing what it can and should do, consistent with the authorizing legislation.

GAO recommendations are contained on page 19.

Whether the small businesses becomes viable depends to a large measure on the practices of the investment companies. Since these practices can promote or hinder the interests of small businesses, they should be carefully watched by the Agency.

This report is the second in a series under to Public Law 93-386 which requires GAO to conduct a full-scale audit of the Small Business Administration.

CHAPTER 1

INTRODUCTION

The Small Business Investment Act of 1958 (15 U.S.C. 661), as amended, authorizes the Small Business Administration (SBA) to license, regulate, and provide supplemental financial assistance to small business investment companies (SBICs).

LEGISLATIVE HISTORY

In 1969 SBA found that the SBIC program was not meeting minority businessmen's needs and initiated a new program for licensing and financing a special class of investment companies to assist specified minority groups. These companies were called minority enterprise small business investment companies (MESBICs).

In 1972 the Congress amended the act adding section 301(d) which specifically authorized the special program and eliminated the inference that the program was only for minority groups. Section 301(d) emphasized that the program should be directed to all socially or economically disadvantaged persons. Accordingly, SBA changed the designation from MESBICs to "301(d) investment companies."

To establish 301(d) investment companies, the Congress provided more liberal conditions than those required of conventional investment companies. The new conditions included more liberal funding provisions and eligibility requirements for SBA matching funds. A 301(d) investment company can receive up to \$3, of long-term subordinated Government funds, from SBA for each private capital dollar. SBA matching funds are provided through the purchase of 301(d) investment company preferred stock or debenture bonds. The preferred stock provides for a 3 percent a year cumulative dividend to SBA that can be deferred until the company pays dividends on its other forms of stock. The debenture bonds may be issued with terms up to 15 years and interest at 3 percent below the average market yield on comparable outstanding U.S. obligations.

With their resources the investment companies provide equity capital, long-term loan funds, and management assistance to small businesses that are at least 50 percent owned and managed by socially or economically disadvantaged businessmen.

Equity investments usually provide for buy-back clauses which define the terms small businessmen must meet to buy back the investments of the 301(d) companies.

REGULATORY FUNCTIONS

SBA is authorized to prescribe regulations governing the operations of 301(d) companies and to carry out the act's provisions. SBA's duties and responsibilities include approving 301(d) companies' articles of incorporation, issuing licenses to 301(d) companies, providing 301(d) companies with financing through the purchase of their debentures and preferred stock, and examining and investigating 301(d) companies to determine their compliance with legal and regulatory requirements. Under its regulatory authority SBA requires 301(d) companies to submit financial statements annually.

When a 301(d) company violates or fails to comply with the provisions of the act or regulations, SBA through the Department of Justice, may take legal action against the company by instituting a civil suit in a U.S. court. Under the act SBA is also authorized to take administrative action against a 301(d) company or its officers, directors, and shareholders through formal hearings which are held by SBA and which can lead to the suspension or revocation of the company's license or to the issuance of a cease and desist order.

PROGRAM GROWTH

The 301(d) investment company program has grown from its inception in 1969 as shown below.

	<u>July 1972</u>	<u>June 1974</u>
Number of companies	50	67
	(millions)	
Private funds	\$16.5	\$29
SBA financial support	5.4	23
Investments in small businesses	4.6	17

As of April 30, 1975, the number of companies had increased to 74. These companies had total funds of \$72.1 million, of which \$36.6 million represented SBA funds. The amount of funds invested in small businesses was not available.

In addition to current investments, the program has resulted in an undetermined amount of (1) investments made but repaid or liquidated, (2) financial commitments and guarantees made but not disbursed, and (3) total leverage--the total value of bank and other financial assistance made possible as a result of program funding. According to an

estimate by the Department of Commerce's Office of Minority Business Enterprise, private capital, when combined with SBA funds and used as equity capital to attract other financing, can actually result in financing up to 20 times the original private investment.

As of April 30, 1975, 301(d) investment companies had been licensed in 26 States, the District of Columbia, and Puerto Rico.

SBA ORGANIZATION

SBA has a central office in Washington, D.C., 10 regional offices, and 81 branch and district offices to aid about 9 million small U.S. businesses. SBA administers 17 different programs, including the 301(d) investment company program. SBA's central administration of this program is done in the Washington, D.C., office by a professional staff of four.

SBA's Examinations Division, with a professional staff of 25, is required to annually examine all companies licensed as 301(d) investment companies. In addition, this office annually examines about 250 conventional investment companies.

CHAPTER 2

OBSERVATIONS ON PROGRAM OPERATION

Under the 301(d) investment company program, SBA must perform two functions: (1) license, regulate, and fund investment companies and (2) aid, counsel, assist, and protect insofar as possible small businesses. SBA has a relatively small centralized staff and relies heavily on the individual investment companies to establish program policies, including the investments' terms.

We believe SBA, in its continuing effort to provide equity financing, needs to be more directly concerned with these companies' practices. SBA's limited involvement has resulted in

- partially used funds and minimal equity investments,
- widely varying management fees,
- buy-back provisions not based on market values,
- restrictive controls over small businesses, and
- funding of small businesses with questionable need.

The 301(d) investment company program is relatively new and has not matured completely; however, SBA can better meet the needs of businesses aided by this program if changes are made in program administration.

AVAILABLE FUNDS ARE ONLY PARTIALLY INVESTED

The analysis of overall program data and the investment activities of ten 301(d) investment companies showed that the available private and Government funds have been only partially used to assist disadvantaged small businesses.

According to financial statements submitted to SBA during the year ended June 30, 1974, sixty-seven 301(d) investment companies had total funds of \$52 million, of which \$23 million represented SBA funds. However, the companies' investments in disadvantaged small businesses totaled only \$17 million, or about 33 percent of available funds.

The following table shows the length of time individual companies have had SBA funds.

<u>Number of 301(d) companies</u>	<u>Months having SBA funds</u>	<u>Average SBA funds</u>
17	1 to 10	\$521,203
6	11 to 20	423,263
6	21 to 30	460,372
1	31 to 40	400,000
1	41 to 60	100,000
<u>36</u>	(a)	(a)
<u>67</u>		

a/According to financial statements submitted during the fiscal year ended June 30, 1974, SBA had not funded these companies.

Of those companies we examined, four had \$5.3 million available for investment, of which \$3 million represented SBA funds. The total amount these companies invested in small businesses was only \$778,590, or about 15 percent of available funds, as shown below.

<u>Company</u>	<u>Funds available as of June 30, 1974</u>	<u>Investments</u>	<u>Percent of funds used</u>
A	\$ 160,407	\$ 7,000	4
B	1,941,918	91,500	5
C	2,683,131	515,000	19
D	<u>484,277</u>	<u>165,091</u>	<u>34</u>
Total	<u>\$5,269,733</u>	<u>\$778,591</u>	15

One of the companies, licensed in June 1972, was incorporated with \$1 million in private funds. In September 1973 it obtained \$1 million in matching SBA funds. However, on March 31, 1974, its recorded investments totaled only \$91,500, or 5 percent of available funds. In addition, the company was negotiating for guarantees and commitments of \$190,000. Unused funds were invested in bank certificates of deposit, the interest from which was used to offset administrative expenses.

Another company, licensed in 1971, was incorporated with \$1 million of private capital. It received matching SBA funds of \$1 million in May 1973 and another \$1 million in

December 1973. It had recorded investments of \$515,000 or 19 percent of available funds. In addition, the company was negotiating for loans and commitments of \$272,000 as of March 31, 1974.

By contrast, the other six companies examined had a total of \$4.1 million available for investment, including SBA funds of \$2.2 million. The total amount invested by these companies in small businesses was \$2.4 million, or about 59 percent of total funds provided--considerably exceeding the national average of 33 percent.

The records maintained by the ten 301(d) companies did not show the number of businessmen denied financial assistance. One official said that his company receives about 200 applications a year, of which only 8 to 10 investments are made.

Several problems were identified that affected the 301(d) investment companies' progress in meeting disadvantaged small businessmen's needs and indicated that the turndown rate for applicants would be high.

A 301(d) company official said that the low-risk investments were generally made by banks and that the 301(d) investment companies were generally only given opportunities to invest in high-risk ventures. Similarly, bank officials and investment company officers attested to the high risk of disadvantaged business investment projects.

Some 301(d) investment company officials said a major factor contributing to the low number of investments was the small business applicants' frequent lack of business skills. A bank official also said the disadvantaged business applicants often lacked necessary management skills. We concluded in a previous report to the Congress 1/ that a lack of management capability was a major reason for disadvantaged business failures.

Manpower constraints, as well as money restrictions, have also been cited as limiting factors by 301(d) investment companies. The American Association of MESBICs in May 1974 observed that staffs were often too small to fulfill their responsibilities.

1/"Limited Success of Federally Financed Minority Businesses in Three Cities" (B-149685, Nov. 8, 1973).

The 301(d) investment company program has only existed since 1969, and individual companies have existed for shorter times. The histories of the 10 companies we examined as of June 30, 1974, follow.

Number of years since company was <u>licensed</u>	Number of <u>companies</u>
Less than 1	1
1	1
2	3
3	4
4	<u>1</u>
	<u>10</u>

Two of the companies shared various investments with associated investment companies which were not licensed 301(d) investment companies. For example, 5 of a single company's 17 investments were made with an associated investment company.

Several other problems affected the program's progress. The policies of some 301(d) investment companies limited investment prospects to members of particular groups or residents within the company's vicinity. Some investment policies were directed to particular types or sizes of investments. Also, the economy affects the program's progress since it affects small business prospects generally and disadvantaged businesses particularly.

INVESTMENT COMPANIES SHOW PREFERENCE FOR LOANS
RATHER THAN MORE RISKY EQUITY PARTICIPATION

Although a major program purpose is increasing the availability of equity financing, loans accounted for a majority of the investments made by the ten 301(d) investment companies. The investment decisions of 301(d) companies have been influenced by the need to obtain immediate operating income. For example, one company with no equity investments stated that it was not subsidized by other organizations and depends on the interest from loans and certificates of deposit as part of its operating income.

Also, SBA investment guidelines issued to the 301(d) investment companies in July 1972 and revised in February 1975 state, in part:

"* * * while Licensees should recognize the need for an appropriate mix of equities and loans so as to provide adequate operating income to meet fixed obligations and expenses, they should, as far as is practicable, emphasize equity investment, with particular attention to growth potentials.

"In the early years of the Licensee, it may be necessary, at least in some instances, for the mix of equities and loans to be weighted in favor of interest-bearing loans without equity. However, as the Licensee and its portfolio companies mature, this trend should be reversed, with equity investments being emphasized * * *." (Underscoring supplied.)

The following SBA analysis of the investments made by 301(d) investment companies covers the 12-month period ended December 30, 1974.

<u>Type</u>	<u>Number</u>	<u>Amount</u>	<u>Percent</u>
		(millions)	
Loans	265	\$ 5.9	47
Debt securities	<u>79</u>	<u>5.3</u>	<u>43</u>
	344	11.2	90
Equity (capital stock)	<u>46</u>	<u>1.2</u>	<u>10</u>
Total	<u>390</u>	<u>\$12.4</u>	<u>100</u>

As shown above, equity investments accounted for only 10 percent of the total amount invested.

Following are examples of the investment activities of some of the companies examined.

--Company A was organized in September 1971. The company had 12 investments in its portfolio in May 1974; only 2 were equity investments and 1 was a combination-- primarily debt security but with a small equity investment included.

--Company B was organized in October 1972. In March 1974 the company had eight investments--all loans.

--Company C was organized in December 1970. In April 1974 the company had 20 investments--17 of which were loans.

Our analysis of the ten 301(d) companies' investments outstanding during our review showed that equity investments accounted for only 19 percent of the total amount invested.

<u>Type</u>	<u>Number</u>	<u>Amount</u>	<u>Percent</u>
Loans	78	\$2,468,512	65
Debt securities	<u>9</u>	<u>604,738</u>	<u>16</u>
	87	3,073,250	81
Equity (stock)	<u>27</u>	<u>702,741</u>	<u>19</u>
Total	<u>114</u>	<u>\$3,775,991</u>	<u>100</u>

Companies have generally favored loans and debt securities rather than equity investments to assist small businesses. Since the program started, 301(d) companies have been opposed to any restrictions on the Government funds obtained. The companies maintain that these funds, which make up part of their equity capital, are useful during the early stages when the interest earned on them helps to defray operating costs. Thus, although companies have recognized the advantages of equity financing for their own operations, they nevertheless generally sought nonequity means of financing the disadvantaged small businesses.

INVESTMENT COMPANY ARRANGEMENTS WITH SOME BUSINESSES APPEAR ONE SIDED

The review of ten 301(d) investment companies primarily covered the investment policies and practices of the companies as they related to management fees and other fees, buy-back provisions, and controls over small businesses.

Management fees

SBA regulations provide that fees for such services as management and technical assistance are not to exceed comparable charges by established professional consultants. Our review of fees showed they ranged from zero to as high as 27 percent of profits before taxes.

One investment company charges flat fees up to \$25,000 for initial management and technical services. In some cases the company also charges additional monthly fees for management services. In one case \$27,000 was advanced as a 1-year loan to a company bidding on a 1-year contract. The terms were 15 percent interest, \$3,500 for professional services, and \$2,400 for management fees, totaling \$9,950.

Another investment company charged four different small businesses 27 percent of net profits before taxes as management fees. These businesses, however, were already receiving extensive management assistance under their franchise agreements with major food companies. Officials of the small businesses said they had little communication with the 301(d) investment company and the fees paid were out of line with the negligible amount of management services provided.

Management assistance by 301(d) investment companies is intended to promote the success of the business and to insure the profitability of the investment. Reasonable management fees can be a substantial source of revenue for the investment companies and can prevent them from operating at a loss. However, excessive management fees burden the already disadvantaged small business.

Buy-back provisions

The terms of the buy-back clauses in the investments varied widely. For example, some were based on predetermined fixed amounts or on fixed prices or book value, whichever was greater, and some were unspecified but open for future negotiation.

The terms of the buy-back clauses examined provided that the small business pay as much as 34 times the amount originally invested. Unless the business is extremely profitable, the disadvantaged small business operator would not be able to accumulate enough funds to buy back the equity interest.

One investment company invested \$5,000 in 5,000 shares of common stock in a small business in June 1973. Buy-back terms provide that the entrepreneur may purchase 4,000 of these shares after 5 years and the other 1,000 after 6 years for between \$125,900 and \$175,140, or between 25 and 34 times original investment.

In January 1974 another company invested \$24,500 in the common stock of a small business. After 5 years the small business operator can buy back the stock for \$330,750, or 14 times the original investment.

The gains made by 301(d) investment companies on the appreciation of equity investments could be major sources of profit. However, if buy-back provisions considerably exceed market value, they may be unduly restrictive to the disadvantaged small business operator.

Excessive controls

Investments made by selected 301(d) investment companies were generally accompanied by restrictive controls and other practices which limited, and possibly nullified, accomplishing management goals. SBA has not developed specific policies or guidelines minimizing these restrictive practices.

Following are examples of several restrictive practices noted.

--The terms of an investment provide that the investment company own and/or control 65 percent of the disadvantaged small business' stock and control two of three members of the board of directors. Unless the small business operator meets certain sales and profit targets as well as other requirements, he can be replaced by the investment company.

--One investment company prescribed the terms of several deals and established the equity terms without negotiating with the disadvantaged small businesses and without giving them adequate opportunity to develop alternative and possibly less restrictive or less costly sources of money.

--The disadvantaged small businesses were, in several deals, required to relinquish control over cash flow and were unable to establish relations with local banks.

Two experienced disadvantaged small business operators felt that the 301(d) investment company controls were excessive and unwarranted.

Reasonable controls are necessary to provide management discipline and help disadvantaged small businesses and to safeguard 301(d) investment company investments. However, excessive controls are burdensome and detrimental to small businesses.

NEED TO DEFINE ELIGIBILITY--
SOME BUSINESSES RECEIVING HELP DID NOT
APPEAR TO NEED ASSISTANCE

SBA has not established clear policies or guidelines to guide 301(d) investment companies in evaluating the eligibility of persons requesting financial assistance. This has resulted in the funding of small businesses that do not appear to need 301(d) investment company services, and continuing this practice could result in the unwarranted exclusion of persons needing assistance.

Program assistance eligibility

The 1972 amendments to the Small Business Investment Act and SBA regulations provide that assistance is to be given to small businesses owned by persons "whose participation in the free enterprise system is hampered because of social or economic disadvantages."

Before the amendments, Executive Order 11625, issued October 13, 1971, stated:

"'Minority business enterprise' means a business enterprise that is owned or controlled by one or more socially or economically disadvantaged persons. Such disadvantage may arise from cultural, racial, chronic economic circumstances or background or other similar cause. Such persons include, but are not limited to, Negroes, Puerto Ricans, Spanish-speaking Americans, American Indians, Eskimos, and Aleuts."

Asians were later added to the list of minority groups, and Vietnam-era service was also added as a contributing factor to be considered in establishing social disadvantage.

SBA has not issued definitive criteria to assist 301(d) investment companies in determining:

- When a person who is not a member of one of the specified minority groups is disadvantaged and eligible for financial assistance.
- Whether a person who, although a minority group member, may not actually be disadvantaged because of improved economic or social conditions.

SBA's policy has been to delegate the responsibility for eligibility determinations to the individual 301(d) investment companies.

Effect of the lack of SBA policy

We reviewed the practices of the ten 301(d) investment companies in evaluating the eligibility of persons requesting financial assistance. Because of the lack of clear policies and guidelines, small businesses with questionable need have received assistance from 301(d) investment companies. This could result in other businesses which may need the assistance being excluded.

Among one investment company's transactions was an investment of \$100,000 made in August 1973 to a small business which had earlier received \$1 million financing from other sources and which was obtaining over \$2 million in additional financing. Anticipated net earnings for the year were expected to exceed \$1 million. The principal was considered eligible because he was a minority group member. Our review disclosed no evidence, however, that the investment company questioned whether the principal could be classified as "socially or economically disadvantaged" or whether, with the wide availability of financial support, he needed 301(d) investment company financial support or management assistance.

Another investment company's transactions showed that, in considering an investment, it was concerned whether a college graduate who had a favorable employment record and had formed his own company in 1968 was eligible. Investment company officials applied to SBA for clarification of the applicant's status as a "socially or economically disadvantaged person" because he could not qualify as a member of a minority group. SBA central office officials advised the investment company that each 301(d) investment company should determine eligibility separately. The investment company determined that the applicant was eligible and completed the transaction.

Our examination disclosed that the investment programs of 301(d) companies continue to be aimed at specific minority groups. At one investment company the investment objectives and promotional literature showed that the investment program was directed toward minorities. All 17 of its investments were made to small businesses whose owners were minority group members. A company official said that the only written guidelines received from SBA were the published regulations which provided that persons were eligible if they were "socially or economically disadvantaged" and a letter adding Vietnam-era veterans for eligibility consideration. All other instructions were verbal.

The lack of clear SBA policies and guidelines concerning eligibility, in addition to affecting the solicitation and development of investment prospects and screening practices of the 301(d) investment companies, weakens the usefulness of SBA's system for monitoring and measuring the program's effectiveness. The SBA evaluation procedures provide for a year-to-year comparison of financial and employment data. The evaluation system, however, does not disclose (1) status of the persons being assisted (minority or socially or economically disadvantaged), (2) income levels, or (3) other criteria. Thus, it does not provide information about whether the program is reaching the intended beneficiaries.

The Congress expressed concern over SBA's eligibility definition during hearings in 1972 and 1973. In June 1972 the Subcommittee on Small Business, House Committee on Banking and Currency, held hearings which were directed partly toward 301(d) program problems, including clarifying the qualifications of persons eligible for financial and management assistance. Also in May 1973 the Subcommittee on Departments of State, Justice, and Commerce, the Judiciary, and Related Agencies, House Committee on Appropriations, inquired into SBA's definition of persons eligible under the 301(d) investment company program.

Previous GAO reports 1/ discussed the lack of adequate eligibility criteria under the 8(a) contract program for disadvantaged businessmen--including the confusion among SBA field personnel in determining who was eligible for program assistance.

IMPROVED MANAGEMENT INFORMATION SYSTEM NEEDED

Neither SBA's reporting system for monitoring 301(d) investment company activities nor SBA examination policies and practices give SBA adequate management information. As a result, SBA is unaware of the details of investment company policies and practices including eligibility determinations, buy-back provisions, and other controls. Also, to a limited degree SBA is unaware of the terms of management fees and other fees.

1/Report to the Chairman, Subcommittee on Minority Small Business Enterprise, House Select Committee on Small Business, entitled "Answers to Questions Regarding Arcata Investment Company and SBA's Section 8(a) Procurement Program" (B-132740, Nov. 21, 1973) and report to the Congress entitled "Questionable Effectiveness of SBA's 8(a) Procurement Program" (GGD-75-57, Apr. 16, 1975).

SBA's program administration is centralized and is performed by a staff of four professionals. SBA requires 301(d) investment companies to report to SBA's central office on each investment in a small business. The report, filed after each investment, includes information on the amount and purpose of the investment transaction, the type of security or other instrument evidencing the transaction, interest rate, discounts, fees, commission and other charges, and other information. It does not provide, however, for information supporting the eligibility determinations, the terms of agreements providing management services and fees, buy-back terms, or the provisions for 301(d) investment company controls over disadvantaged small businessmen.

SBA's Examination Division also examines each 301(d) investment company annually. However, these examinations are limited to determining compliance with statutory requirements and SBA regulations, and to determining whether financing practices comply with SBA procedural requirements.

For example, although SBA's information system alerted officials in 1972 that a 301(d) investment company was charging management fees ranging from 20 to 27 percent of pre-tax profits, the reports submitted by the company were not required to and did not include the type of management services provided or information concerning the buy-back terms of investments. The examination reports made by the Examination Division in September 1972 and in September 1973 also did not include information concerning buy-back terms.

SBA's management reporting system, also, does not provide information concerning the extent of financial and operating controls over the activities of disadvantaged businessmen or information concerning the basis for determining the businessman's eligibility.

CHAPTER 3

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

The 301(d) investment company program is designed to enlist private capital to assist socially or economically disadvantaged small businesses. Concerning these companies, SBA's mission under the Small Business Investment Act of 1958 includes licensing, regulating, guiding, and, in part, providing investment funds. Concerning the small businessmen, SBA's mission under the Small Business Act is to aid, counsel, assist, and protect insofar as possible the small businesses' interest.

We recognize that the 301(d) investment company program is relatively new. Patterns have already emerged from program operations that warrant actions by SBA.

- Available funds are only being partially invested.
- For those businesses receiving help, the investment companies are opting for loans rather than more risky equity participation.
- Granted the risks assumed by the investment companies, some of their arrangements with small businesses appear to be one sided.
- The Small Business Administration has essentially adopted a hands-off approach to the program, preferring what it terms "the capitalistic way."

Although the Small Business Investment Act Amendments of 1972 require that persons receiving financial assistance under the 301(d) investment company program be socially or economically disadvantaged, SBA's policy has been to delegate the responsibility for determining eligibility to the individual investment companies. The lack of clear SBA policies and guidelines has resulted in the funding of small businesses that may not need assistance and could exclude those businesses that need assistance.

SBA also needs to take a more effective role to insure that individual 301(d) investment companies provide opportunities to all businesses owned by socially or economically disadvantaged individuals. The lack of definitive guidelines also weakens SBA's self-evaluation system's effectiveness.

Better management information could result if improvements were made in the reporting system for monitoring 301(d) investment company activities.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on our report, SBA maintained that it did not manage the 301(d) companies nor did it make investment decisions for them. SBA stated that, after it was assured of the character, integrity, and competency of management of a 301(d) investment company, it then regulated these companies in accordance with the Administrative Procedure Act.

SBA agreed that equity investments have not been of the desired percentages and that it could do more to direct 301(d) companies to make equity and equity-type investments in disadvantaged small business concerns. According to SBA, fostering this trend is the third and fourth dollar leverage of its funding authority. That is, 301(d) companies are eligible for additional SBA funding providing a required or specific percentage of equity investments are met. SBA, however, did not indicate any action it planned to take to improve the level of equity investments.

Regarding the program's progress, SBA stated that the relatively low percentage of available funds used did not necessarily indicate a low impact in the overall assistance rendered to small businesses. SBA stated that:

"* * * Many small business concerns that have sought assistance from licensees have been able, through the efforts of the licensee, to obtain regular bank financing or assistance from other sources. Unfortunately, statistics in this respect are not available. However, from information received from time-to-time by SBA from licensees, the program has a definite impact, albeit indirectly, on the small business community which cannot be measured in terms of dollars invested by the licensees."

We agree that the program has had some indirect impact; however, SBA should be concerned with the program's primary purpose--providing equity capital to disadvantaged small businessmen. Moreover, we recognize that the program was relatively new and had not matured completely at the time of our review.

SBA agreed to take action concerning fee guidelines. It indicated that the matter of fees was being studied, and that the situation would be rectified in those instances in which management fees were tied into profits.

SBA advised that buy-backs were permissible; however, it stated that the cost of the buy-back was not easily determined. In addition, SBA advised that, although its policy required that the terms of buy-back provisions be determined between buyer and seller, it hoped that the small businesses become profitable. SBA also advised that a great deal of private capital was at stake and that all investment and internal decisions must be those of the licensee's board of directors and officers. SBA concluded that for it to give guidelines on how to obtain an adequate return was most presumptuous.

We agree that a precise determination of buy-back terms can be complex. However, in these transactions the position of the small business is of paramount importance, which is the essential reason why SBA should be involved.

SBA advised that its regulations relating to the 301(d) company control over a small business were intended to avoid operating control.

SBA indicated that, to assure that 301(d) investment companies were operating under the act and regulations and carrying out the congressional intent it furnished all companies with policy and procedural releases. Although SBA revised these releases in February 1975, we do not believe that the changes will solve the problems discussed in this report because the new releases essentially restate the policies and procedures in previous releases. Further, the individual investment companies may continue investment practices that will either promote or hinder the interests of disadvantaged small business operators.

SBA agreed that there is a need to assist 301(d) companies in determining eligibility for their financial assistance. SBA stated that it intends to get out a Policy and Procedural Release directed toward advising licensees concerning eligibility determination of socially and economically disadvantaged.

In addition, SBA advised that it intends to revise its Portfolio Financing Report to include information as to the terms of agreement for management services and fees, buy-back terms, and control features.

RECOMMENDATIONS

We recommend that the Administrator establish policies and guidelines to assist 301(d) investment companies in assessing management fees to assure reasonable earnings for the companies but also to assure that the small businessman is required to pay only fees that are commensurate with the value of management services rendered.

To insure that maximum benefits are achieved from program funds, we recommend that the Administrator:

- Develop guidelines that define specific factors 301(d) investment companies should consider in declaring persons eligible for program assistance.
- Require that investment companies document all decisions regarding eligibility and particularly show the connection between a person's social or economic disadvantage and his inability to compete successfully in the business world.

Also, SBA--as the advocate of small business--needs to assure that the practices of 301(d) companies do not limit the small businessmen's progress toward becoming viable and independent. Accordingly, we recommend that the Administrator improve the management control over the program by requiring that 301(d) companies provide more meaningful management reports.

CHAPTER 4

SCOPE OF REVIEW

We made our review at SBA headquarters in Washington, D.C., the SBA regional and district offices in Chicago, and ten 301(d) investment companies in or near Chicago, San Francisco, Dallas, and New Orleans. We also interviewed bank and investment company officials and persons receiving assistance from the companies.

Our review at the investment companies included an examination of corporate minutes and financial statements, accounting records, and files pertaining to investment made, rejected, or being considered by the companies. It also included examining SBA loan dockets and related files pertaining to bank and SBA financial assistance provided to selected small businesses.

Our review was directed toward analyzing program problems which, if corrected, should result in a more effective program. Accordingly, we were concerned primarily with weaknesses in the SBA administrative process rather than whether particular weaknesses were representative of the activities of all 301(d) investment companies.



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

OFFICE OF THE ADMINISTRATOR

April 23, 1975

Victor L. Lowe, Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

As requested by your letter of March 18, 1975, the following are our comments on each of the findings in your draft report titled "Improvements Needed in the 301(d) Investment Company Program: Assisting Socially or Economically Disadvantaged Businessmen":

"Need for greater SBA guidance
over 301(d) investment company activities"

(See GAO note, page 27.)

As you know, and fully realize, SBA does not manage the 301(d) companies nor does SBA make investment decisions as such. The program is the capitalistic approach to help solve the lack of accessibility for entrepreneurship to socially and economically disadvantaged. SBA licenses, regulates, and in part finances these companies.

After licensing, that is after SBA has assured itself to the best of its ability under established policies and procedures of the character, integrity, and the competency of management, SBA then regulates these companies under the Act and Regulations in accordance with the Administrative Procedures Act.

With this in mind, and clearly understood, and with the inherent problems of licensing, regulating and funding with a limited staff of four professionals SBA could do more to assist the 301(d) companies in attempting to direct them to make equity and equity type investments in socially and economically or disadvantaged small business concerns. With a view to assisting 301(d) companies in operating under the Act and Regulations and carrying out the Congressional intent as licensees, SBA does furnish all licensees with Policy and Procedural Releases (recently amended and updated).

- 2001 -- Application for Prior or Post Approval of An Exemption With Respect to Licensee Actions and Other Required Submissions to SBA
- 2004 -- Size Determination for Concerns Assisted by SBICs Section 301(d) Companies
- 2009 -- Investment Guidelines
- 2015 -- Financial Assistance Contrary to Public Interest

SBA has also provided all day seminars for 301(d) companies and applicants. There is also a National Trade Association, the American Association of Minority Small Business Investment Companies, which have regional and national meetings in which SBA participates.

"Need for guidance and support of equity financing

(See GAO note, page 27.)

While equity investments have not been of the desired percentages, we trust that trend will be towards more equity and equity type investments. The third dollar leverage and possible fourth dollar should foster this hopeful trend. The definition of "Venture Capital" as used in the SBA regulations and forming the basis for the third dollar leverage was not considered in your report. It should be noted that 301(d) companies must have some income to pay interest even though the interest is subsidized for five years.

(See GAO note, page 27.)

"Need for improved policies and guidelines in establishing management and other type fees"

and

"Need for improved policies and guidelines in establishing buy-back provisions"

Management fees do vary but so long as they comply with the regulations and the management agreement has SBA approval this is the free determination between the 301(d) company and the small business man. The same applies to buy-back provisions. These are not easy matters for precise determination. We hope the SBC becomes profitable. The more profitable

the better and we hope the equity position of the 301(d) company in turn makes a profit. When the 301(d) company makes a \$5,000 equity investment, the chances are it has made a loan to the SBC many times that amount and a great percentage of the "Money" risk in the business is from the 301(d) company: thus the capitalistic way. The report philosophizes about SBA providing guidelines as to investments and monitoring to assure adequate returns on this equity investment.

On balance, however, we reiterate that the licensees are privately owned and operated, with a great deal of privately injected capital at stake and all investment and internal decisions must be those of the licensees' Board of Directors and the Officers, provided that the decisions are not in contravention with the Act or Regulations. The terms of the equity investment must, of course, also be agreed to by the small business concern. For SBA to presume to give guidelines on how to obtain "adequate return" is most presumptuous.

The basic purpose of lending under the Small Business Act is to make loans when funds are not "otherwise available on reasonable terms" from other lending institutions. An equity investment by an SBIC or a 301(d) company is different from a loan with interest within the Regulation. Equity investments, with its intended purpose of capital appreciation, are based on negotiations between and the final decisions of the buyer and the seller.

(See GAO note, page 27.)

It was the purpose of the Small Business Investment Act to provide a vehicle for equity funds for small firms; however, regulations of the Investment Division prevent SBICs and 301(d) companies from taking over the ownership or control of small firms by use of the equity vehicle.

"Need for policies and guidelines
to prevent excessive controls"

Our present regulations relating to control over the SBC is intended to avoid operating control. At the same time as a creditor or investor, a 301(d) company should be permitted to protect its investment, and it exercises such investment control as is necessary. The socially or disadvantaged small business man or woman still runs the SBC. This does not mean the small business man or woman can take the capital of the business for other than business purposes.

"Low program impact"

The fact that a relatively low percentage of available funds has been utilized by the companies does not necessarily indicate a low impact in the overall assistance rendered to small business concerns. Many small business concerns that have sought assistance from licensees have been able, through the efforts of the licensee, to obtain regular bank financing or assistance from other sources. Unfortunately, statistics in this respect are not available. However, from information received from time-to-time by SBA from licensees, the program has a definite impact, albeit indirectly, on the small business community which cannot be measured in terms of dollars invested by the licensees.

"Need to define who is eligible for assistance"

As to who is the socially or economically disadvantaged, this is a matter involving serious constitutional questions. For this reason, a specific definition is most difficult. Attempts have been made for years, particularly since the creation of Office of Minority Business Enterprise in the Department of Commerce. They and other agencies and organizations have this problem.

The 301(d) companies do file an SBA Form 652A which gives an assurance of compliance with nondiscrimination requirements of the Law and Regulations. However, to assist 301(d) companies in their endeavors to determine eligibility for their assistance (i.e., companies owned by socially or economically disadvantaged), we intend to issue a Policy and Procedural Release which will contain guidelines and criteria to be considered. The release will include similar factors to those contained in SOP 60 41 1, utilized by SBA's Section 8(a) program.

"Need for improved management information system

(See GAO note, page 27.)

Basically, we do not believe that your review established a basis for recommending that SBA needs to improve management control to -- "Provide for more detailed reports from 301(d) investment companies and broader based SBA audits, including coverage of program aspects, to assure that SBA is fully aware of the practices of the 301(d) investment companies." Underlined for emphasis only.

In regard to the contents of a Chapter 4, it is felt that the examination reports are generally more than sufficient in supplying the facts upon which a decision can be based as to whether or not the 301(d) company is in violation of the Act or Regulations.

It must be remembered that the examination is a fact finder for regulatory purposes and that it is not an audit. Examinations are an essential regulatory tool.

Sometimes under any given facts (no matter how extensive) it is questionable whether under these facts the Act or Regulations have been violated. This determination is made by the Investment Division and often more facts are needed and are sought or an investigation with subpoena powers is requested. Many times these are close decisions of interpretation, often disagreed to by the 301(d) company or any SBIC. The ultimate decision is often determined through administrative proceedings or in court. This is the administrative process as it should be.

(See GAO note , page 27.)

As to the example referred to in the report

"management fees" (control has been discussed above), these facts were brought to the attention of the operating staff in the examination report.

It has been determined that "buy backs" are permissible. The cost of the "buy back" or "put" has been the difficult question. At one time no more than book value was permitted at the time of the put. This was changed to leave it as the determination between the buyer and the seller. This is because at the time of the investment the true value of the stock at the time of put is not known, and when the put date arrives the small business concern will either buy back or not buy back. In any case, there are no violations of the regulations as now constituted.

With respect to the "management service," this regulation (Section 107.601) has been the subject and of great concern and significant confusion within the industry. It was amended in November 1973 under Revision 5 of the regulations and it was again amended in January 1975. Whether the management fees ranging "between 20 - 27 percent" (of the pre-tax profits) fall within Section 601 of the regulations was questioned by the 301(d) company which contended that this was the equity kicker and that the small business man was getting 80 - 73 percent of such profits.

(For instance, it is common in the theatre industry, that when an investment is made in a play or movie, the investor gets a percentage of gross receipts.) Additionally, in the case at hand no fees were paid. It also may be questioned whether or not Section 107.301 (cost of money) of the regulations should not come into play in this case.

The matter of fees is being studied, and the Investment Division is now of the view that it is not a question of whether or not the management or advisory agreement should have been approved by SBA but a question of the fees themselves. Management or advisory fees should not be tied into profits, and any equity kicker should be obtained through the conventional route, i.e., equity securities, or securities having equity features, i.e., convertible debentures or debentures with warrants. This will be rectified.

We believe the above examples brought out by the report dramatically illustrate the many hundreds of sundry and diverse fact situations that constantly come up involving the regulations and their interpretations.

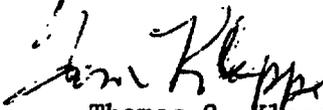
Regulation is not a precise science. It must never be forgotten that regulation involves the property rights and the private rights of people. As James M. Landis (former Dean of the Harvard Law School and former Chairman of the S.E.C. and C.A.B.) once said, "The fact that administrative agencies are the products, not of dogma or of abstract theory, but of the gradual development of control by a democratic government over the varying phases of our economic life, makes generalization about their functions and about the powers that they should be permitted to exercise not only difficult but frequently superficial and misleading."

Therefore, in summary we have agreed to take actions as indicated above with regard to your recommendations concerning guidelines on

eligibility and fees; however, we do not believe that any further action is necessary from what we are already doing with regard to the other recommendations made in your report.

We appreciate the opportunity to comment on this report, and if we can be of further assistance, please advise.

Sincerely,



Thomas S. Kleppe
Administrator

GAO note: Deleted comments refer to material contained in draft report which has been revised or which has not been included in the final report.



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

August 20, 1975

Mr. Victor L. Lowe
Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

This will refer to our meeting of August 20, 1975, regarding the draft report on the 301(d) Investment Company Program.

Please be advised that SBA intends to get out a Policy and Procedural Release directed towards advising licensees with respect to eligibility determination of socially and economically disadvantaged. In addition, we intend to revise our Portfolio Financing Report (SBA Form 1031) to include information as to the terms of the agreement for management services and fees, buy back terms and control features. We appreciate your cooperation.

Sincerely,

Signed

James Thomas Phelan
Deputy Associate Administrator
for Finance and Investment

PRINCIPAL SBA OFFICIALS RESPONSIBLE FOR
ADMINISTERING THE ACTIVITIES DISCUSSED IN THIS REPORT

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	From	To
ADMINISTRATOR:		
Thomas S. Kleppe	Jan. 1971	Present
Hilary Sandoval, Jr.	Mar. 1969	Jan. 1971
DEPUTY ADMINISTRATOR:		
Louis F. Laun	Sept. 1973	Present
Anthony Chase	Feb. 1971	Sept. 1973
Einar Johnson	June 1970	Feb. 1971
W. Donald Brewer	Oct. 1969	June 1970
Richard B. Blankenship	Mar. 1969	Oct. 1969
Howard Greenberg	Aug. 1967	Mar. 1969
ASSOCIATE ADMINISTRATOR FOR FI- NANCE AND INVESTMENT (note a):		
Ronald G. Coleman (acting)	Feb. 1975	Present
Einar Johnson (acting)	Jan. 1975	Feb. 1975
David A. Wollard	Feb. 1973	Jan. 1975
ASSOCIATE ADMINISTRATOR FOR OPERA- TIONS AND INVESTMENTS (note a):		
Stephen H. Bedwell, Jr. (acting)	Oct. 1972	Feb. 1973
Claude Alexander	Feb. 1972	Oct. 1972
Arthur H. Singer	June 1971	Feb. 1972
ASSOCIATE ADMINISTRATOR FOR INVEST- MENTS (note a):		
Arthur H. Singer	Mar. 1969	June 1971
DEPUTY ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENTS:		
James T. Phelan	Aug. 1967	Present

a/The position responsible for the investment activity changed in June 1971 from Associate Administrator for Investments to the Associate Administrator for Operations and Investments. In February 1973 the investment activity was transferred to the Associate Administrator for Finance and Investments.

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