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DECISION

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

FILE: B-149685 DATE: OCT 19 1976

MATTER OF: "Venture Capital" - Section 303(b) of the Small Business Investment Act

DIGEST: Investments (including certain long-term loans) by small business investment company (SBIC) in small business concerns which otherwise meet the requirements of 15 U.S.C. § 683(b) (Supp. IV, 1974) and implementing regulations, do not lose their character as "venture capital" even though the SBIC-lender reserves right to approve or disapprove future borrowings of small business concern from other potential lending institutions.

This decision to the Administrator of the Small Business Administration (SBA) is in response to his request for our concurrence in SBA's interpretation of the term "venture capital" as that term appears in section 303(b) of the Small Business Investment Act, as amended, 15 U.S.C. § 683(b) (Supp. IV, 1974), and in the implementing regulations, 13 C.F.R. § 107.202(b) (1975). SBA has determined that funds loaned by small business investment companies (SBICs) to a small business concern under an agreement requiring the borrower to obtain the SBIC's approval before borrowing money from any other institutional lender can qualify as "venture capital" under the definition, notwithstanding the definitional requirement that venture capital financing be subordinate to any subsequent borrowings by the small business concern. The question is whether we agree that the two requirements are consistent.

According to the material submitted to us by SBA, a question about the validity of this determination was first raised in an internal SBA memorandum addressed to its General Counsel. The internal memorandum points out that if an SBIC has the right to disapprove any additional borrowing by a concern to which it has furnished equity capital, it could defeat the requirement that its own loan be "subordinated" by simply refusing to permit the concern to borrow from anyone else. SBA's administrator, however, has concluded that "an investment is not disqualified from serving as the basis of third-dollar leverage by the requirement of the lender's approval for subsequent loans from other institutional lenders, so long as such investment does not, in fact, become senior to other borrowings of the small concern from other institutional lenders." We concur with SBA's position for the reasons discussed below.

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SBICs have statutory authority to provide financing to eligible small business concerns pursuant to sections 304 and 305 of the Small Business Investment Act, 15 U.S.C. §§ 684 and 685 (Supp. IV, 1974). Section 304 provides that it shall be a function of each SBIC to provide a source of equity capital to eligible small business concerns. Section 305 authorizes each SBIC to make long-term loans to such concerns to provide them with funds needed for sound financing, growth, modernization, and expansion.

Section 303(b) of the Small Business Investment Act authorizes SBA to purchase or guarantee debentures issued by SBICs in amounts up to 300 percent of the total private capital invested in that SBIC, up to a maximum of $20,000,000, provided that the SBIC has a minimum of $500,000 of private capital and has at least 65 percent of its total funds available for investment in small business concerns invested or committed in "venture capital." This is referred to as providing "third dollar leverage" to SBICs. If an SBIC is unable to satisfy those conditions, section 303(b) authorizes SBA to purchase or guarantee only a maximum of 200 percent of the total private capital invested in the SBIC with a $15,000,000 ceiling. Thus, it is in the interest of the SBIC to have its investments qualify as "venture capital" under the statute.

"Venture capital" is defined in general terms in section 303(b) to include "such common stock, preferred stock, or other financing with subordination or nonamortization characteristics as the Administration determines to be substantially similar to equity financing." As authorized by the provision, SBA expanded the statutory definition of venture capital in its regulations as follows:

> "'Venture Capital Financing' shall mean:
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> "(1) Common and preferred stock and equity securities as defined in § 107.302(b)(2) with no repurchase requirement for five years, except as may be specifically approved by SBA under § 107.901 for purposes of relinquishing Control over a Small Concern.
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> "(2) Any right to purchase such stock or equity securities.
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> "(3) Debentures or loans (whether or not convertible or having stock purchase rights) which are subordinated (together with security interests against the assets of the Small Concern) by their terms to all borrowings of the Small Concern from other institutional lenders, and have no part amortized during the first three years." See 13 C.F.R. § 107.202(b)(1975).

Section 304(b) of the Small Business Investment Act, 15 U.S.C. § 684(b)(1970), expressly permits an SBIC providing equity capital to a small business concern to restrict any future borrowings by the small concern as follows:

> "Before any capital is provided to a small-business concern under this section---
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> "(1) the company may require such concern to refinance any or all of its outstanding indebtedness so that the company is the only holder of any evidence of indebtedness of such concern; and
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> "(2) except as provided in regulations issued by the Administration, such concern shall agree that it will not thereafter incur any indebtedness without first securing the approval of the company and giving the company the first opportunity to finance such indebtedness." (Emphasis added.)

If the terms "equity capital" and "venture capital" were the same, no question of eligibility for third-dollar leverage would be raised since authority for prior approval is specifically granted in section 304(b), above. However, as the legislative history indicates, the term "venture capital" is considerably broader in scope. Nonconvertible long-term loans clearly fall in section 305 rather than section 304 and therefore it cannot be said that the prior approval requirement is statutorily authorized.

When the Small Business Investment Act was first enacted in 1958, equity capital for purposes of the Act was limited to convertible debentures only. See S. Rep. No. 1052, 85th Cong., 2d Sess. 12, 10 (1958). (A convertible debenture is a certificate of indebtedness or bond that can be exchanged for stock in the company.) However, in subsequent legislation this statutory restriction was eliminated and SBA was authorized to adopt, through the issuance of appropriate regulations, its own definition of the term "equity capital." The definition, adopted by SBA is considerably broader than that provided in the 1958 Act. It includes stock and other similar forms of financing while retaining convertible debentures--together with other convertible debt instruments--in the equity capital definition. See 13 C.F.R. § 107.302 (1975).

The phrase "venture capital" was added to section 303(b) of the Small Business Investment Act by section 205 of the Small Business Act Amendments of 1967, approved October 11, 1967, Pub. L. No. 90-104, 81 Stat. 268. The initial version of S. 1362, 90th Cong., 1st Sess.,

the bill which was ultimately enacted as Pub. L. No. 90-104 did not contain that term. It used the words "equity capital" instead.

The Conference Report on S. 1862, the bill ultimately enacted as Pub. L. No. 90-104, explained the change as follows:

> "Section 207 of the House amendment contained a definition of 'venture capital.' Section 205 of the conference substitute adopts the term 'venture capital,' but defines it as including 'such common stock, preferred stock, or other financing with subordination or nonamortization characteristics as the Administration shall determine to be substantially similar to equity financing.' Since the term is used only in section 303(b) of the act (as amended by section 205 of the conference substitute), the definition is made part of that section." See H.R. Rep. No. 660, 90th Cong., 1st Sess. 9 (1967).

This explanation was amplified by Senator McIntyre in presenting the conference report to the Senate:

> "The Senate version of S. 1862 leaves to the determination of the SBA Administrator the definition of 'equity capital' as it would be used in section 303(b) of the act.
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> "The House version defines 'venture capital' without granting any discretion to the SBA Administrator.
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> "The conference committee accepted the Senate provision to permit the final definition to be left to the SBA Administrator but changed 'equity capital' under this section to read 'venture capital.' This will permit SBA to accept as eligible securities a variety of debt instruments which do not meet the technical qualifications of equity but which are substantially similar to equity financing." 113 Cong. Rec. 27128 (Sept. 28, 1967).

As indicated in the foregoing explanation, by adopting the term "venture capital" instead of "equity capital" and moving the definition to section 303, Congress maintained the separate provisions applicable to equity capital under section 304 and to long-term loans under section 305 while encouraging, through the leverage provisions of section 303, certain types of investments--including those which may be substantially similar but do not meet the technical qualifications of equity financing--from both categories.

Our review of the legislative history of the Small Business Investment Act, as amended, has shown a consistent concern on the part of Congress to protect as well as encourage equity type investments by SBIC's. The following explanation of the purpose and objective of the relevant provisions of the Small Business Investment Act approved August 21, 1958, Pub. L. No. 85-699, 72 Stat. 689, as it was originally enacted, supports this view:

"EQUITY-TYPE CAPITAL FOR SMALL BUSINESSES

"Small-business investment companies are authorized to provide equity-type capital to small-business concerns through the purchase of convertible debentures which shall contain such terms and interest rates as the companies fix under SBA regulations. These debentures are to be convertible at the option of the company or a holder in due course, up to and including the date of call, into stock of the small-business concern at the sound book value of such stock as determined at the time the debentures were issued.

"The committee believes that the use of convertible debentures, which has been developed to a high degree in recent years by many large, publicly financed companies, is the most suitable financing instrument for this type of program. This type of debenture is attractive to speculative investors who want an opportunity to share in the future prosperity of a business beyond the fixed claim of ordinary debt. In view of the risk inherent in, and the admittedly experimental nature of the financing which this bill seeks to encourage, consideration must be given to encouraging such speculative investors.

"Before an investment company purchase any such convertible debentures, it may require the small-business concern to refinance its outstanding indebtedness so that the investment company is the only holder of indebtedness of such concern. Furthermore, to protect the investment company, such small-business concern may be required to agree not to incur further indebtedness without approval of the investment company." H.R. Rep. No. 2060, 85th Cong., 2d Sess. 8, 15 (1958. See also S. Rep. No. 1052, 85th Cong., 2d Sess. 12 (1958).

The legislative history of the Small Business Investment Act Amendments of 1960, approved June 11, 1960, Pub. L. No. 86-502, 74 Stat. 196, is also significant for purposes of this issue. The initial version of

S. 2611, 86th Cong., 1st Sess., the bill which was ultimately enacted as Pub. L. No. 86-502, would have deleted from the Small Business Investment Act the borrowing approval provision presently found at section 304(b) of the Act. Although the Senate initially passed this version of S. 2611, the deleted provision was restored by the House of Representatives with the accompanying explanation:

> "The Senate bill omits from existing law certain provisions restricting additional borrowing by small business concerns to which an SBIC has supplied capital under section 304. None of the witnesses who appeared during the hearings expressed any complaint about the way these provisions are working today, and many letters were received indicating that their omission from the revised section 304 would be misunderstood. To the extent that the SBIC's investment under section 304 takes the form of a debt instrument, it should have some control over additional debt incurred by the borrower. Your committee concluded, therefore, that it would be best to leave these provisions as they are in existing law. They appear as subsection (b) of section 304 of the 1958 act, as it would be rewritten by the reported bill." (Emphasis added.) See H.R. Rep. No. 1608, 86th Cong., 2d Sess., 8 (1960).

The Senate agreed to this action by the House of Representatives in restoring the deleted provisions after Senator Proxmire explained the House amendment to the Senate as follows:

> "Section 6 of the Senate version of S. 2611 would eliminate the language contained in section 304(c), which provides that before any capital is provided to a small business concern, first, the SBIC may require such concern to refinance any or all of its outstanding indebtedness so that the SBIC is the holder of any evidence of indebtedness of the small business concern; and, second, except as provided in SBA regulations the small business concern shall agree that it will not thereafter incur any indebtedness without first securing the approval of the SBIC and giving the SBIC the first opportunity to finance such indebtedness.
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> "The House version of S. 2611 provides for the retention of the language of section 304(c) in the act.
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> "This is not objectionable since these provisions have not to my knowledge caused any hardship to either

> the SBIC's or small business concerns. They are the type provisions that would normally be included in any financial arrangement whether they are expressly set out in the act or not. SBA regulations provide that the SBIC shall allow appropriate exceptions to this section for open account or other short-term credit." (Emphasis added.) See 106 Cong. Rec. 11672 (June 2, 1960).

It is true that the foregoing expressions of intent refer to equity capital financing under section 304 rather than long-term loan transactions under section 305. Nevertheless, we are persuaded that Congress, in enacting section 304(b), did not intend to preclude SBICs who make long-term loans under section 305 from similarly protecting their funds. We note that section 305(c) of the Act requires that loans made by SBIC's "shall be of such sound value or so secured, as reasonably to assure repayment." We agree with SBA that a restriction on new borrowings may be of great assistance in carrying out the mandate of section 305(c).

From the foregoing it is our view that by including section 304(b), the Congress intended to assure that SBICs providing financing under the provisions of section 304 would be able to take advantage of a restrictive provision often included as a matter of commercial practice in the type of long-term long financing contemplated under section 305 rather than to authorize the practice for equity financing but prohibit the practice for such long-term loan financing. That is, a provision which places a limitation on other indebtedness by the borrower is used in most loan agreements as part of a lender's design to assure the borrower's liquidity and ability to pay the loan back. See, for example, J. Van Horne, Financial Management and Policy 558-560 (3d ed., 1974). Providers of equity capital are not as often thought of as having such protections and we believe the provision in question was included to avoid any doubts that SBICs supplying equity capital to small business concerns were covered. It would be anomalous to hold that the Congress intended to authorize SBICs to protect only their equity capital investments but not their investments of other types of venture capital.

In summary, it is our view that Congress did not intend to preclude SBICs making long-term loans under section 305 from requiring small business concern borrowers, as a condition to obtaining their loans, to agree to secure the SBIC's approval before incurring additional indebtedness, nor did it intend to preclude long-term loans from being considered investments or commitments in venture capital if they meet the other criteria established by the statute and SBA's implementing regulations, merely because the borrower is required to obtain the lender's approval for subsequent loans from other institutional lenders.

R.F. KELLER

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