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2 Major Policy Changes Lessen Regulatory Burdens On SBICs

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Two significant changes in the laws applicable to small business investment companies (SBICs) and their advisers occurred in December 2015:

(1) SBIC investment advisers will now have reduced registration requirements under the Investment Advisers Act of 1940 (the “Advisers Act”), thanks to the passage of the SBIC Advisers Relief Act; and

(2) The cap on the amount of outstanding U.S. Small Business Administration leverage for a “family” of commonly controlled SBICs was increased from $225 million to $350 million pursuant to an amendment to the Small Business Investment Act of 1958.

SBIC Advisers Relief Act

The amendments contained within the SBIC Advisers Relief Act fall into three primary categories, which are described below.

(a) Advisers Solely to SBICs Are No Longer Subject to State Registration Requirements

Perhaps the biggest win for SBICs under the SBIC Advisers Relief Act is the extension of the federal preemption of the exemption for SBIC-only advisers. Under the new act, investment advisers who are exempt from federal registration because they only advise SBICs are no longer subject to state investment adviser registration requirements — any state requirements are now preempted by the federal exemption. This is similar to the preemption from state registration enjoyed by banks.

Prior to the passage of the SBIC Advisers Relief Act, SBIC fund advisers relying on this exemption from federal registration were still subject to state regulation. This meant complying with state exemption

requirements, state regulatory reporting requirements and, in some cases, registration with state regulators, all of this even if the SBIC adviser is exempt at the federal level.

(b) SBIC Capital is Now Excluded From Assets Under Management for the Private Fund Adviser Exemption

Investment advisers that advise both SBICs and non-SBIC private funds may now, pursuant to the SBIC Advisers Relief Act, exclude the SBIC assets from the calculation of regulatory assets under management for purposes of the $150 million private fund adviser limit.

Previously, an adviser who advised private funds other than SBICs could still be exempt from U.S. Securities and Exchange Commission registration if the total regulatory assets under management of all of such funds together, including SBICs, was less than $150 million. The regulatory assets under management of the SBIC in this calculation would include the gross asset value of all assets plus uncalled limited partner commitments, as well as the value of assets purchased with SBA leverage. Thus, very few SBIC advisers who also managed other funds were able to take advantage of the private fund adviser exemption. The SBIC Advisers Relief Act changes this rule to exclude the assets under management of an SBIC from the calculation.

Investment advisers who advise relatively large SBICs along with smaller private funds (including, for example, side car funds and funds that previously were SBICs and have surrendered their SBIC licenses during the fund wind-down process) will likely benefit from this exemption. Even if exempt under the federal private fund adviser exemption, these advisers may, however, still be subject to state regulation and will be subject to federal “exempt reporting adviser” reporting requirements. However, many states now have companion exemptions for a federal “exempt reporting adviser” relying on the private fund exemption.

(c) Advisers to SBICs and Venture Capital Funds May Now Use the Federal Exemption for Venture Capital Funds

Investment advisers who only advise SBICs and venture capital funds are now able to rely on the exemption from federal registration available to advisors solely to venture capital funds.

Before passage of the SBIC Advisers Relief Act, although an adviser solely to SBICs was exempt from federal registration and an adviser solely to venture capital funds was also exempt, an adviser to both SBICs and venture capital funds (but not other funds) was not exempt. The SBIC Advisers Relief Act remedies this through an amendment that states that a venture capital fund includes an SBIC for purposes of the venture capital fund exemption. An adviser that is exempt from federal registration under this provision will be required to report as an “exempt reporting adviser” and will be subject to any applicable state regulation.

Increase in the Leverage Limit for a Family of SBIC Funds

The primary benefit for SBICs participating in the SBA debenture program is the ability to obtain leverage capital from the SBA. An increase in the SBA leverage limit for a family of commonly managed SBICs from $225 million to $350 million is a key change that allows qualifying SBICs to obtain up to an additional $125 million of such leverage. In addition, an important impact of this change, which we discuss below, is that many fund families taking advantage of the increase in leverage will also raise additional capital from limited partners (LPs).

(a) Increase in SBA Leverage Limit under the Amended Law

A single SBIC is limited to $150 million of outstanding SBA leverage under the Small Business Investment Act of 1958, which governs SBICs. However, fund managers can be approved by the SBA for licenses for two or more SBIC funds. Prior to passage of the amendment to the Small Business Investment Act of 1958 (contained within the 2016 omnibus budget appropriations law passed in December 2015), the limit on the total amount of leverage for multiple SBICs under “common control” was $225 million. Therefore, a fund manager with multiple SBICs could, for example, have one SBIC with $150 million of leverage and another SBIC with $75 million of leverage.

The amendment will allow a group of commonly managed SBIC funds to obtain up to an additional $125 million of SBA leverage, for a total of $350 million across the group of commonly managed SBICs. The amendment does not modify the $150 million limitation for the amount of leverage that can be obtained by a single SBIC. Therefore, under the new requirements, a group could have, for example, two SBICs with $150 million of SBA leverage each and a third SBIC with $50 million of leverage.

The new law does not alter the requirements for obtaining an SBIC license or SBA leverage commitments. Fund managers will still need to apply for and obtain SBA approval for any new SBIC licenses and the applicable leverage commitments.

(b) For Many Funds, Increased SBA Leverage Will Mean Additional LP Capital

The amount of SBA leverage that an SBIC may obtain is based on a multiple of the SBIC’s private LP capital. The maximum ratio of SBA leverage to private LP capital that the SBA will generally approve is 2-to-1 (although the SBA can approve up to 3-to-1 in certain situations). Thus, if a family of commonly managed SBICs with total SBA leverage of $225 million is leveraged 2-to-1, the SBICs would need to have $112.5 million of LP capital, resulting in aggregate capital across the funds of $337.5 ($112.5 million + $225 million).

For 2X leveraged SBICs, an increase of $125 million in leverage would mean an increase in total capital of $187.5 million for the fund family ($125 million of leverage + $62.5 million additional capital raised from LPs), or an aggregate of $525 million across the commonly managed SBICs versus $337.5 million under the prior version of the law. It is important to note, however, that the Small Business Investment Act of 1958 does not limit the amount of private LP capital an SBIC (or a group of SBICs) may raise. In addition, some leveraged SBICs are approved to obtain such leverage on less than a 2-to-1 basis. Therefore, single SBICs and SBIC families could have significantly higher amounts of LP capital, and thus, total fund sizes, than in this 2-to-1 leverage ratio example.

(c) Increase in the Leverage Limit Will Result in Opportunities for Larger SBIC Fund Families, Including BDCs

The Small Business Investor Alliance estimated that approximately 30 percent of debenture “family of funds” in the SBIC program were hitting the $225 million leverage cap or were at risk of hitting the cap if they raised their next fund. This amendment to the law likely will result in such fund families (and new entrants to the SBIC program) having the opportunity to raise additional LP capital and to obtain additional SBA leverage. In addition, although Congress authorized $4 billion in SBA leverage for 2016 (as in 2015), less than $2.6 billion of SBA leverage has been committed to SBICs in any prior given year. Therefore, capacity exists in the SBA program for additional SBA leverage commitments.

In addition to traditional private equity-structured vehicles, one subset of investors likely to take advantage of the increase in the SBA leverage limit are business development companies (“BDCs”). The SBIC program has been popular for BDCs in recent years. With a permanent capital base, BDCs are well-positioned to take advantage of the higher limit by contributing additional BDC capital into an SBIC vehicle and obtaining additional SBA leverage.

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