Hearing on "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Barriers"
House Committee on Financial Services
Subcommittee on Capital Markets & Government Sponsored Enterprises
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Testimony by Gayle G. Hughes
Partner & Founder, Merion Investment Partners
On behalf of the Small Business Investor Alliance
www.SBIA.org

Good afternoon Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee on Capital Markets and Government Sponsored Enterprises:

My name is Gayle Hughes and I'm a founder and partner of Merion Investment Partners (Merion), a family of private equity funds licensed by the Small Business Administration (SBA) as Small Business Investment Companies (SBICs). Merion is based outside of Philadelphia and was founded in 2003. Merion currently advises two SBIC funds and is involved in providing subordinated debt and equity to small businesses that have significant growth potential. I am here today representing the Small Business Investor Alliance (SBIA), which is the trade association of lower middle market private equity funds, SBICs, and business development companies (BDCs) and their institutional investors. SBIA members provide vital capital to small and medium-sized businesses across the country. I'm also here to express my support for the SBIC Advisers Relief Act.

Background

Before I delve into the details of why I'm here testifying today, it might make sense to share a little of my background, and the background of Merion Investment Partners. Over my 30 year career in the financial industry, I have worked with companies, from small entrepreneurial firms to Fortune 500 companies; I have found working with small businesses to be the most rewarding. As such, for the last 20 years, my partners and I have worked as a team investing and managing mezzanine debt and equity investments in small businesses. We have also worked closely with the management teams of the companies we invest in to help them achieve their growth objectives. For the first six years, our group worked within the framework of Mellon Growth Finance, a concept and team founded by my partner Bill Means, where we built a portfolio of small business investments that included several notable successes in the greater Philadelphia region.

As the core of our strategy was to invest in small entrepreneurial businesses and provide them with the financial wherewithal and management expertise to realize their growth objectives, we decided to pursue an SBIC license. As a result, we left Mellon Bank in 2002 and formed Merion. Our first SBIC license was approved by the SBA in August of 2003. We sought a second license, which was approved in January 2010, and we plan to seek a third license later this year. Today we advise total "assets under management" (AUM) of just over $105 million and employ a staff of six people in Radnor, PA to run our operations. Since 2003, our funds and management company have been examined 14 times by the SBA.

Since receiving our first SBIC license, we have invested nearly $190 million in 35 small businesses throughout the country. A large percentage of our investments are made directly with entrepreneurs and business owners, with Merion providing the only institutional capital. As such, we work closely with the businesses we invest in to help them professionalize their management, grow their business, and expand their teams. For example, we provided financing used to finance a growth opportunity for an IT services company located in northern New Jersey that tripled the firm's revenues, expanded its footprint and nearly doubled its employee base during our investment period. In a second example, we provided financing for two independent businessmen to acquire a catalog retail and e-Commerce business from an owner seeking a

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transition. Merion provided the capital for the management transition of this company located in central Virginia. As the new owners were better equipped to take advantage of certain growth opportunities, the company grew revenues at a 23% compound annual growth rate and increased its employment base by 67% during our investment period. In addition, I am pleased to note that of the 23 different states represented by members of the committee, Merion has made investments that are either headquartered in or have significant operations in 78% of those states.

Merion actively invests in small businesses and works closely with those entrepreneurs, their management teams and their equity investors, if any, to grow revenues, reach new markets, and expand their workforce and to provide a return to our investors. We have a strong record of success in this regard over our years of investing and unfortunately the cost and time associated with duplicative regulatory burdens would materially reduce the time we could be spending with small businesses focused on their growth and development.

"SBIC Advisers Relief Act" Fixes Duplicative Regulation Issue for Merion
Merion is currently facing a problem that a number of other investment advisers solely to SBIC funds have had to face and address, which arises during the wind-down phase and at the end of a particular SBIC fund's life. As each fund is a discreet pool of capital independently licensed by the SBA, traditionally once an SBIC has paid off their SBA debentures in full and is winding down its operations and exiting the small remaining pool of investments, it would turn in its SBIC license for that fund. This was an efficient solution, as it enabled the SBA staff to focus on the oversight of active funds (still engaged in investing) and it reduced the cost burden to the fund (and its investors) of ongoing compliance with the SBA regulations and reporting on a very small asset base. Merion reached this milestone in 2012 with its first fund.

As we embark on fund raising for our third fund, Merion III, the small investments remaining in our first fund, Merion I, would most certainly trigger full registration with the SEC, and associated regulatory burdens, if we do not retain our SBIC license on this small remaining pool of capital. This is because the combined capital of Merion I and Merion III would exceed $150 million of AUM and therefore be required to register with the Securities and Exchange Commission (SEC) as an investment adviser and be subject to duplicative cost and burden of both registering with the SEC, and ensuring ongoing compliance with the SBIC regulations and SBA oversight. These regulatory burdens would be a long-term expense and administrative drain for our fund. Often an orderly wind down of a fund can take one to two years, in order to meet the timelines of the remaining small businesses, as well as maximize returns for the investors. This would therefore create ongoing registration risk, and associated cost and burden over that time period for the fund managers.

This issue could be easily remedied through the passage of pending legislation, called the SBIC Advisers Relief Act, on behalf of which I am testifying today. The SBIC Advisers Relief Act, or H.R.432, was introduced in the House on January 21, 2015, by Representatives Blaine Luetkemeyer (R-MO), Carolyn Maloney (D-NY), and eight other bipartisan cosponsors. In the 113th Congress, the same legislation passed the House Financial Services Committee 56-0, and was approved by the House on a voice vote. Senators Mark Kirk (R-IL) and Joe Manchin (D-WV) introduced the Senate companion (S.2765) to the bill in the 113th Congress.

My written testimony explains in more detail the elements of this legislation, and why the solutions and clarifications it makes to the Dodd-Frank Act are necessary to ensure that smaller funds will be able to continue focusing on small business investing, rather than filling out regulatory paperwork. I would like to thank the Subcommittee for examining this bill today and I especially want to thank the sponsors of the legislation.

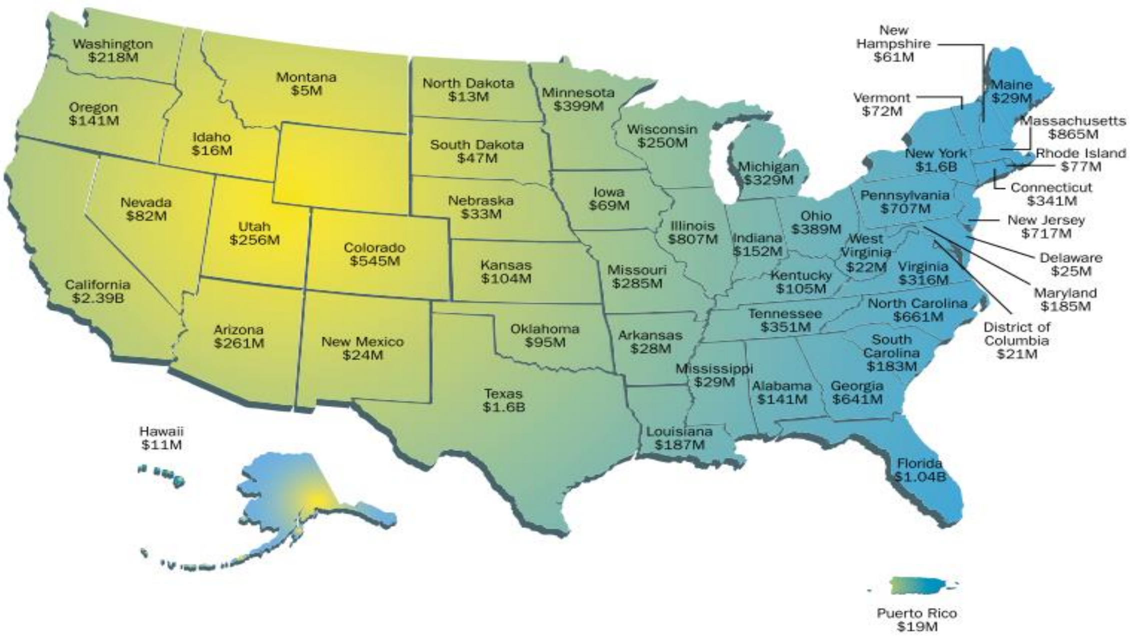
In addition to the SBIC Advisers Relief Act, the SBIA believes other legislation that is the subject of the hearing today will contribute to improving access to capital and reducing associated regulatory burdens in the capital raising and deal sourcing process. SBIA supports legislation that helps improve capital formation and reduce regulatory burdens for small businesses. Several bills are consistent with these goals including the Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2015 (H.R. 686), the Disclosure Modernization and Simplification Act of 2015 (H.R. 1525), and the Improving Access to Capital for Emerging Growth Companies Act (H.R. 1659).

I. What is an SBIC?

Before discussing the benefits of the SBIC Advisers Relief Act, it makes sense to provide a quick overview of what exactly is an SBIC. SBICs are privately owned, managed, and operated equity investment funds that make long-term investments in U.S. small businesses and are licensed by the SBA. SBICs are highly regulated private funds that invest exclusively in domestic small businesses with at least 25% of their investments in even smaller enterprises. The program was created in 1958 to help overcome the scale challenges associated with small business investment, and in so doing spearheaded creation of the thriving venture capital industry we see in the country today. Given their clear public benefit, SBIC funds are the only explicitly permitted investment under the Volcker Rule that was set out in statute.

Currently, there are over 294 licensed SBICs across the country with over $22 billion in total assets. In Fiscal Year 2014, SBICs invested more than $5.2 billion in capital in domestic small businesses, adding to the $63 billion in total investments in small businesses provided since 1958. Well-known companies such as Costco, Apple, Federal Express, Outback Steakhouse, and Callaway Golf received SBIC financing when they began, growing into successful, profitable companies and employing thousands of Americans. SBICs also are based in many areas where traditional private equity is not, with funds based in Tennessee, Louisiana, Pennsylvania, Alabama, Arkansas, Illinois, Nebraska, Kansas, Virginia, Rhode Island, New York, New Jersey, Massachusetts, and Indiana, among others.

Total Small Business Investment Companies
Investments by State (FY 2010-2014)



II. Dodd Frank Prompted a Significant Change in How SBIC Advisers and Private Fund Advisers Were Regulated

Under the Dodd-Frank Wall Street Reform & Consumer Protection Act (Dodd-Frank), passed in 2010, the landscape for investment advisers changed dramatically for private equity funds. In writing Dodd-Frank there was discussion, and amendments were adopted, with the express intent of avoiding duplicative regulation and reporting by SBICs. Unfortunately, as the bill evolved there were drafting oversights that inadvertently undercut the premise of not redundantly regulating SBICs and preventing the resulting drain on the resources of small business investors. The changes required many private equity funds to register with the SEC as investment advisers, and smaller private equity advisers to provide limited reporting to the SEC or register with their state securities regulator. Registration for these smaller funds is not just filling out a few forms; it is a new way of life. SEC registration is expensive and, in many cases, the investment adviser rules are not very applicable to private equity funds dealing in non-public securities, which is common with small funds.

The initial cost to register with the SEC is often in excess of $100,000. Annual costs to comply with SEC investment adviser rules are often $50,000 or more per year. SBIA supports exempting small business investors from the Investment Advisers Act. The $150 million threshold that triggers SEC registration is too low and, at a minimum, should be raised. It is illustrative that one of the authors of Dodd-Frank, former Congressman Barney Frank, recently stated that Congress should consider amending the $150 million threshold with which private equity firms must register with the SEC; while further highlighting that "in the crisis situation, we erred on the side of maybe being too inclusive."[1]

Dodd-Frank created a new "Assets under Management" or AUM test to determine the regulatory burden on investment advisers to private funds. Other types of fund advisers are specifically exempt from registration, such as venture funds (VC) and SBICs, but only if they "solely" advise those funds. The following chart explains the requirements:

Size or Type of Fund Test	**Regulatory Regime**
Investment Advisers that advise PE Funds more than $150 Million in AUM	*Required to Register with the SEC as an Investment Adviser.*
Investment Advisers that advise PE Funds between $100-150 Million in AUM	*Regulated by the SEC as an "Exempt Reporting Adviser," i.e., no registration, generally no examinations, but paperwork and reporting to the SEC.*
Investment Advisers that advise PE Funds with less than $90-100 Million in AUM	*Register with the state securities regulator, depending on state law and applicable state exemptions for private funds.* ***Currently, 25 states, plus the District of Columbia, do not have exemptions from registration for Advisers to SBIC Funds, resulting in duplicative regulation.***
Investment Advisers that "solely" advise VC funds	*Regulated by the SEC as an "Exempt Reporting Adviser," i.e. no registration, generally no examinations, but paperwork and reporting to the SEC.*
Advisers that "solely" advise SBIC Funds	*SBICs are already Regulated by the SBA. Therefore, Congress exempted from SEC Registration. Depending on state law, the Investment Adviser may have to register with the state regulator if there is no state exemption or order.*
Advisers that advise SBIC Funds and VC Funds	*SBICs and VC Funds lose both of their Exemptions and Must Register with the SEC if their AUM is greater than $150 Million. This Results in Duplicative Regulation from the SEC and SBA over SBIC Funds.*
Advisers that advise SBIC Funds and PE Funds	*The SEC includes the SBIC AUM in the SEC Registration calculation, triggering automatic registration if above $150 Million in AUM. This Results in Duplicative Regulation from the SEC and SBA over SBIC Funds.*

[1] Deborah Cohen, *Frank Pushes for Change to PE Registration Rule in Dodd-Frank-Reuters,* MIDDLE MARKET GROWTH, January 22, 2015, *available at:* http://www.middlemarketgrowth.org/frank-pushes-change-pe-registration-rule-dodd-frank-reuters/

The chart above explains the confusing and inconsistent framework that is currently in place due to the changes to the investment adviser regulation under Dodd-Frank. The SBIC Advisers Relief Act aims to clarify these inconsistencies and provide relief for smaller funds which are disproportionately impacted by duplicative and costly regulation. This bill is vital for a number of particular reasons.

Small business investors commonly have very few employees, sometimes as few as two. Small business investment funds, such as Merion, generally do not have legal departments, compliance teams, or extra employees to spare adhering to a complicated regulatory regime that is not designed for its type of investing. Adding additional overhead expenses for regulatory compliance teams and services damages the ability of small business investment funds to operate profitably and prevents them from dedicating all their time, energy, and capital to helping small businesses grow.

The cost of registration and additional compliance functions is high for smaller funds because their management fees[2] (which are a function of assets under management) are low when compared to much larger funds; however, smaller funds face many of the same compliance and reporting levels as larger funds. Absent the infrastructure of larger funds, smaller funds often have to pay outside counsel to help with initial and ongoing compliance costs.

Due to the relatively high compliance expense, managers of smaller funds are left with two choices – raise far more capital for their next fund to cover the fees for the added compliance costs or exit the business. Larger funds invest in larger companies, generally not small businesses. Neither option delivers a positive result for continuing the flow of capital to small businesses. For every $1 that we spend on compliance issues, that is $1 less that we have to further our mission to deploy capital and to help grow the economy. Therefore, all the time and money that is tied up by regulatory compliance will hinder economic growth and job creation.

The SBIC Advisers Relief Act seeks to eliminate duplicative regulation that imposes significant burdens and costs on small business investment funds by clarifying and eliminating inconsistencies in the regulatory framework in the Dodd-Frank Act. These modest changes are technical corrections that will ensure that small business investment will not be penalized and pushed out of the marketplace, and America's small businesses will receive the capital they need.

III. The SBIC Advisers Relief Act (H.R. 432)

The SBIC Advisers Relief Act is a common-sense, bipartisan, and effective clarification of the investment adviser regulation that will enhance the ability of small business investors to concentrate on making investments, rather than filling out forms. It concentrates on three targeted changes to current law. First, the legislation prevents venture funds from losing their

[2] Most private equity limited partnership agreements (LPAs) require costs associated with SEC registration and ongoing regulatory compliance to be charged as a management expense, being paid by the management fee, rather than a fund cost. Management fees are typically 2% of the total AUM of the funds being advised, and cover the costs of operating the investment adviser, paying staff and for office space, deal sourcing and due diligence, as well as other expenses.

exemption from SEC registration when entering the SBIC program. Second, the legislation helps advisers to both private equity funds and SBICs by removing the SBIC capital, which is already regulated by the SBA, from the AUM calculation for SEC registration. Third, the legislation prevents the duplicative registration of SBICs by federal and state securities regulators and returns SBICs to their original sole regulator - SBA.

1) Eliminating the Barrier for Venture Funds to Utilize the SBIC Program

The new ERA regime for venture funds in Dodd-Frank failed to provide sufficient guidance to the SEC on how to treat dual advisers of both venture and SBIC funds. The Dodd-Frank Act states that the SEC cannot register advisers that "solely" advise SBIC funds. The SEC then applied the term "solely" to mean that if an adviser oversaw a single penny outside of SBIC fund assets, then duplicative regulation was triggered. This was not the Congressional intent of Dodd-Frank and serves no practical investor protection or public benefit. As a result, while advisers to venture funds may remain ERA advisers if they only advise a venture fund, if they also enter the SBIC program with another venture fund, they are now required to register – a much more expensive proposition. As a result, venture funds are effectively penalized with additional costs if they choose to add an investment vehicle for domestic small business investments. This legislation would allow venture fund advisers to remain ERAs if they choose also to advise an SBIC fund.

This provision is particularly important when it comes to encouraging VC fund advisers to enter the SBIC program. As part of the Obama Administration's "Start-Up America Initiative," in 2012, the SBA implemented a new Early-Stage SBIC program to promote innovation and job creation by encouraging private sector investment in job-creating early stage small businesses. The purpose of the program is to target a gap in investment for early-stage companies outside the traditional venture areas of California, Massachusetts, and New York. If a VC fund adviser chooses to utilize the Early-Stage SBIC program, under current law, they will lose their exemption from SEC registration and be subject to the cost and burden of SEC registration. Congressman Mick Mulvaney (R-SC) put it best at a hearing on the legislation last Congress when he described the issue, explaining that "If A, you don't have to register with the SEC, if B, you don't have to register with the SEC, but if A+B, you do have to register with the SEC." Clearly, such an approach to securities regulation doesn't make much sense, nor is it protecting many investors.

a) The Regulatory Contradiction Faced by Noro-Moseley Partners

One of SBIA's members, Noro-Moseley Partners (Noro-Moseley), is a venture fund investment adviser founded in 1983, and based in Atlanta, Georgia. The fund has seven employees. Noro-Moseley is now investing in its 7th fund and focuses its investments on venture and early growth stage healthcare and IT companies across the United States. Noro-Moseley currently has four funds still operating, one small VC fund in wind down, one VC fund with about $150 million in AUM, one Early-Stage SBIC, and a parallel VC fund with $110 million in AUM split between the two parallel funds, for a final tally of $260 million AUM. Noro-Moseley received its Early-Stage SBIC license in 2013, as one of the first VC funds entering this new SBIC program. When entering the program, they were advised by their attorneys that the SEC was likely to provide relief from SEC registration due to this very issue. Unfortunately, the SEC declined to provide such relief, after initial positive conversations. As a result, Noro-Moseley, because they entered the SBIC program and lost their VC "solely" exemption, was forced to spend over $100,000 in initial costs to register with the SEC, plus $25,000-to-$50,000 for annual, ongoing compliance costs. These are costs and time that could be better spent seeking out VC investments and getting capital to small businesses. Also, Noro-Moseley, themselves, have expressed doubt about whether they would have entered the SBIC program had they known they would be required to register with the SEC and incur the related compliance costs and burdens.

2) Exempting SBIC Capital from the SEC AUM Registration Threshold

Advisers that advise both SBIC funds and private funds, such as have to include the AUM of the SBIC fund in addition to the private fund they manage in calculating the threshold for SEC registration. This legislation would exempt already federally regulated SBIC capital from being included in the triggering calculation for SEC registration for those advisers jointly advising both SBIC and other small private funds, and prevent these advisers from being penalized for raising a large SBIC fund specifically formed to invest in domestic small businesses.

a) The Impact on Spell Capital Partners

In addition to Merion, one of SBIA's members, Spell Capital Partners, would be directly helped by this provision in the SBIC Advisers Relief Act. Spell Capital's focus is on staying small and investing in small, entrepreneurial companies primarily in the manufacturing space. The firm currently employs a staff of 16 people in Minneapolis, Minnesota. Spell Capital's SBIC fund has been examined twice by the SBA since they were licensed in March 2013. Their funds have created thousands of jobs and invested in many companies since the firm was formed over 25 years ago. Currently, Spell Capital has 21 companies in their portfolio that they have invested in debt, equity, or, in some cases, both.

Spell advises three funds: Fund III, a private fund with about $39 million AUM; Fund IV with $46 million AUM; and an SBIC with $86.6 million AUM. Under the current SEC AUM calculation, they are required to register with the Commission as a result of having over $171 million AUM with the SBIC capital included. All of their investors are accredited investors and include high net worth individuals, banks, insurance companies, family offices, and foundations. Spell Capital will soon be filing a Form ADV to register with the Commission and expect their initial registration costs, calculated in both time and financial costs, to be $75,000-to-$100,000, with annual estimated ongoing compliance costs to be $50,000-to-$80,000.

The SBIC capital Spell is advising is thoroughly examined and regulated by the SBA, while the private capital in their non-SBIC funds will still continue to be looked at by the applicable SEC or state regulator. The key here is that with this bill, all of the capital Spell oversees and their investment adviser will continue to be regulated in full by one sole regulator, rather than the SEC regulating the private and SBIC capital. This legislation will save the firm immense compliance- and time-based costs that will allow Spell Capital to focus on what they do best – investing in innovative small companies in the manufacturing sector, which often do not have sufficient access to capital.

3) Duplicative Registration of SBICs

The authors of Dodd-Frank specifically prevented the SEC from registering advisers that solely advise SBIC funds, recognizing the need for only one regulator and identifying the lower pain thresholds of small business investors. However, this section of Dodd- Frank inadvertently opened up SBIC funds, regulated by the SBA since 1958, to duplicative regulation because it was silent on the concept of state regulation of federally licensed SBIC funds. Duplicative regulation at the federal level was considered and rejected. Unfortunately, it was erroneously assumed that this issue was settled, but state regulation of federally licensed SBICs was not expressly prohibited. Funds now have confusion, costs, and doubled regulatory burdens. A small number of state securities regulators have reserved the right to interpret Dodd-Frank as giving them authority to regulate the advisers of federally licensed SBICs which have less than $100 million in AUM. The SBIC Advisers Relief Act would return SBIC advisers solely advising SBIC funds below $100 million in AUM to federal oversight by their licensing agency, the SBA. States would still have authority to register advisers not solely advising SBICs.

a) Duplicative Regulation by State and Federal Governments

Another one of SBIA's members, Diamond State Ventures (Diamond State), a fund named as the SBIC of the Year in 2011 by the SBA, recently was impacted by this very issue in the state of Arkansas. Diamond State, based in Little Rock, has been involved in the SBIC program since 1999, and the team has successfully been licensed three times by the SBA to operate an SBIC, most recently in February 2014. The fund's investors are predominately banks (70%), along with pension funds, private foundations, and a few high net worth individuals. Diamond State is the sole SBIC in the state of Arkansas, a state underserved by private equity and small business investing. Diamond State has three employees. Since inception, Diamond State has made over 18 investments in small businesses located in the state of Arkansas, employing over 2,300 Arkansans and investing over $40 million in Arkansas companies. Diamond State is currently under the $100 million AUM threshold that would be required to avoid state registration. If they were above this threshold, they would be exempt from SEC registration and would remain solely regulated by the SBA.

Because of the murkiness of the securities laws across the states, when Diamond State raised their most recent federally licensed SBIC fund in January 2014, they consulted with the Arkansas Securities Commissioner to make sure they were staying on the straight and narrow. They were informed that because Arkansas did not have a "private adviser" exemption, they would be required to register with the state regulator[3], in addition to the regulation and oversight they already receive by the SBA. It is important to note that the SBA has conducted an on-site examination of Diamond State every year since 1999, and conducted a rigorous licensing review

[3] Note: There is no exemption for in-state investment advisers to private funds in the state of Arkansas: http://www.nasaa.org/industry-resources/investment-advisers/ia-switch-resources/state-investment-adviser-registration-information/arkansas/

of the entire team each time they have been licensed by the SBA. In the midst of determining whether registration applied to Diamond State, the fund spent over $50,000 in legal fees trying to figure out how to apply the state securities regulations to their federally licensed SBIC fund, which were designed to apply to brokerage firms and retail investment advisers, not advisers to private equity funds or SBICs. Further costs in time and money were imposed as the then two-person team spent the majority of their time for over three months working on this regulatory issue, rather than out searching for potential small business investments. In the end, the fund will have spent thousands of dollars to prepare for a potential exam with an Arkansas examiner who likely will have little to no understanding or experience with the regulations and requirements of the federal SBIC program or how this type of firm is required to operate.

There are inconsistent and confusing standards across the states. Some of the states that do not have an exemption have expressed to SBICs in their state that they recognize the existing SBIC registration exemption in Dodd-Frank and the legislative intent to avoid duplicative regulation so they don't need to formally register at the state level. Given that these states have had since July 2010 (when the investment adviser switch implementation began[4]) to update their laws, it seems unlikely they are planning on updating them in the near future. Moreover, many states that do exempt registration for SBIC funds over $100 million AUM under a "federally covered" adviser section of their state securities laws end up forcing the funds to enter a different regime at the state level because, technically, those funds are not registered with the SEC due to their SEC exemption in Dodd-Frank. This illustrates the immense confusion about the silence on this issue in Dodd-Frank and promotes significant regulatory uncertainty for funds. Congress intended for the SBA to be the sole regulator of SBICs, but did not make that clear in the drafting of the statute. This bill will provide the technical correction needed to provide clarity and consistency.

IV. SBICs Are Heavily Regulated by the SBA

SBICs are heavily regulated and closely supervised by SBA. This review and oversight starts before an applicant is permitted to file a formal license application with SBA and continues until such time as that license is surrendered or revoked. SBIC management undergoes an extensive background check prior to licensing. The regulatory regime has similarities to, but is also much more intense than, that applicable to other private funds that are regulated by the SEC. It is important to note that in contrast to the SEC and state securities regulators, the SBA reviews not only the investment adviser operations, it evaluates and vets the entire management team of the investment adviser *and* examines the operations and investments of the fund entity as well. Ultimately, if the SBA feels that an SBIC is being operated poorly, it can step in and force that fund into SBA liquidation – something that is not the case with a private fund regulated by the SEC or a state securities regulator.

The SBIC regulatory regime consists of an in-depth examination and review of the fund's management prior to licensing covering stringent investment rules, operational requirements, recordkeeping, reporting, examinations, conflict of interest rules, and other significant

[4] *The IA Switch, a Successful Collaboration to Enhance Investor Protection*, North American Securities Administrators Association, May 2013, p. 11, *available at:* http://www.nasaa.org/wp-content/uploads/2011/08/IA-Switch-Report.pdf

requirements. For a more in-depth understanding of the rigorous regulatory regime imposed on SBIC funds, we have provided a helpful addendum to this testimony.

V. SBIA Recommendation: Pass the SBIC Advisers Relief Act

Due to the tailored nature of this legislation, the necessity to clarify the elements of Dodd-Frank to eliminate duplicative regulation, and the fact that all of these funds will continue to be subject to regulation once this legislation passes, Congress and this Committee should act swiftly to pass the SBIC Advisers Relief Act.

VI. Other Legislation That Would Reduce Regulatory Burdens in Deal Sourcing and Capital Raising, Resulting In Improved Access to Capital

A number of other pieces of legislation under review at this hearing would be beneficial to SBIA's members. These include the Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2015 (H.R. 686), the Disclosure Modernization and Simplification Act of 2015 (H.R. 1525), and the Improving Access to Capital for Emerging Growth Companies Act (H.R. 1659). These bills are very helpful in streamlining the regulatory process that companies and certain funds have to surmount in order to be available for small and mid-sized businesses to access capital.

A. M&A Broker Legislation (H.R. 686)

SBICs, as well as SBIA's other members, BDCs and traditional lower middle market private equity funds, often utilize M&A brokers to help match together smaller companies with capital providers. These brokers are often critical to smaller companies that might not be based in urban areas with easy access to the capital providers, and may not have a direct line of communication to a lender. M&A brokers currently operate in a difficult arena, in the mix between state and federal securities laws. While a recent SEC no-action letter provided some relief to these brokers[5], this legislation is needed to provide a permanent safe harbor for these brokers, and subsequent protection from heavy cost and regulatory burden associated with broker-dealer registration.

The recent SEC no-action relief is limited to specific circumstances, while passing H.R. 686 would contribute to a broader exemption for M&A brokers at the federal level. Providing relief for these M&A brokers will bolster middle market and lower-middle market M&A, which will lower costs for small and mid-size companies seeking to unlock their value through a sale or engaging in a financing transaction for future growth. While SBIA would prefer to address the problem of disparate regulatory and registration regimes in state blue sky laws, which H.R. 686 does not address, we believe this bill is a step in the right direction.

[5] M&A Brokers, January 31, 2014, available on the SEC's web site at https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf

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B. Disclosure Modernization & Simplification Act and the Improving Access to Capital for Emerging Growth Companies Act

SBIA represents a number of BDCs, which are reporting companies that would benefit from improved disclosure reform at the SEC. While the thrust of SBIA's effort has been involved in making a number of reforms in BDC Modernization legislation, we believe H.R. 1525 helps reduce some of the regulatory burdens and costs incurred by not only BDCs, but other reporting companies. H.R. 1525 directs the Commission to make certain common-sense changes to help reporting companies such as BDCs, and eliminate duplicative filing requirements and unnecessary paperwork. SBIA also supports the SEC studying how to modernize and simplify disclosure to ensure investors are receiving information that is actually relevant, clear, and material. This type of study is far overdue, and necessary to ensure the disclosure regime is updated for the 21st century investor.

SBIA member BDCs are eligible for Emerging Growth Company (EGC) status and almost all newly formed BDCs have elected to be treated as EGCs, illustrating the attractiveness of this new creation in the JOBS Act, and how helpful EGC status is as a BDC moves towards an initial public offering (IPO). This legislation makes helpful changes to the SEC registration and disclosure requirements to help EGCs access the capital markets more quickly, and move efficiently to IPO.

Biography – Gayle G. Hughes, Partner, founder of Merion Investment Partners and a former member of the Mellon Growth Finance team at Mellon Bank. Ms. Hughes has over 30 years lending experience and has spent over half of her career working with entrepreneurial firms providing growth capital via leveraged cash flow and mezzanine debt. Ms. Hughes was previously an investment banker at Marine Midland raising debt and equity capital for growing companies.

Ms. Hughes earned an AB Economic/Business at Lafayette College. Ms. Hughes has served through the years and currently participates as a Board member or in an observer role for certain of the Merion portfolio companies. She also serves on the Board of the Small Business Investor Alliance ("SBIA") and is a former President of the Northeast Region of the SBIA.

Addendum I to Testimony

<u>Basic Overview of the Regulatory Regime for Small Business Investment Companies</u>

A Small Business Investment Company ("***SBIC***") is a privately owned, managed, and operated equity investment fund that makes long-term investments in U.S. small businesses and is

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licensed by the United States Small Business Administration ("***SBA***"). The SBA program is established under the statutory authority in the Small Business Investment Act of 1958, as amended, and SBA regulations promulgated thereunder. A principal reason to seek an SBIC license is to gain access to financing (called "***Leverage***") provided by SBA. Banks often invest in SBICs to obtain credit under the Community Reinvestment Act (the Dodd-Frank Act and the Volker implementing regulations continue to permit these bank investments). Leverage is in the form of 10-year loans, with no amortization until maturity and with interest generally payable semi-annually. Current Leverage authorization levels are $3 billion per year. A licensed SBIC can obtain Leverage in an amount up to twice the SBIC's private capital, but most stay well below this level. SBIC Leverage is provided at a zero subsidy rate, meaning there is no cost to the taxpayer. Since its establishment in 1958, the SBIC program has provided over $63 billion of funding to U.S. small businesses.

SBICs are heavily regulated and closely supervised by SBA. This review and oversight starts before an applicant is permitted to file a formal license application with SBA and continues until such time as the license is surrendered or revoked. SBIC management undergoes an extensive background check prior to licensing. The regulatory regime has similarities to, but is also much more intense than, that applicable to other private funds that are regulated by the Securities and Exchange Commission. The SBIC regulatory regime consists of an in-depth examination of the management, stringent investment rules, operational requirements, recordkeeping, reporting, examinations, conflict of interest rules, and other significant requirements. Below is an overview of the comprehensive regulatory and oversight environment applicable to SBICs.

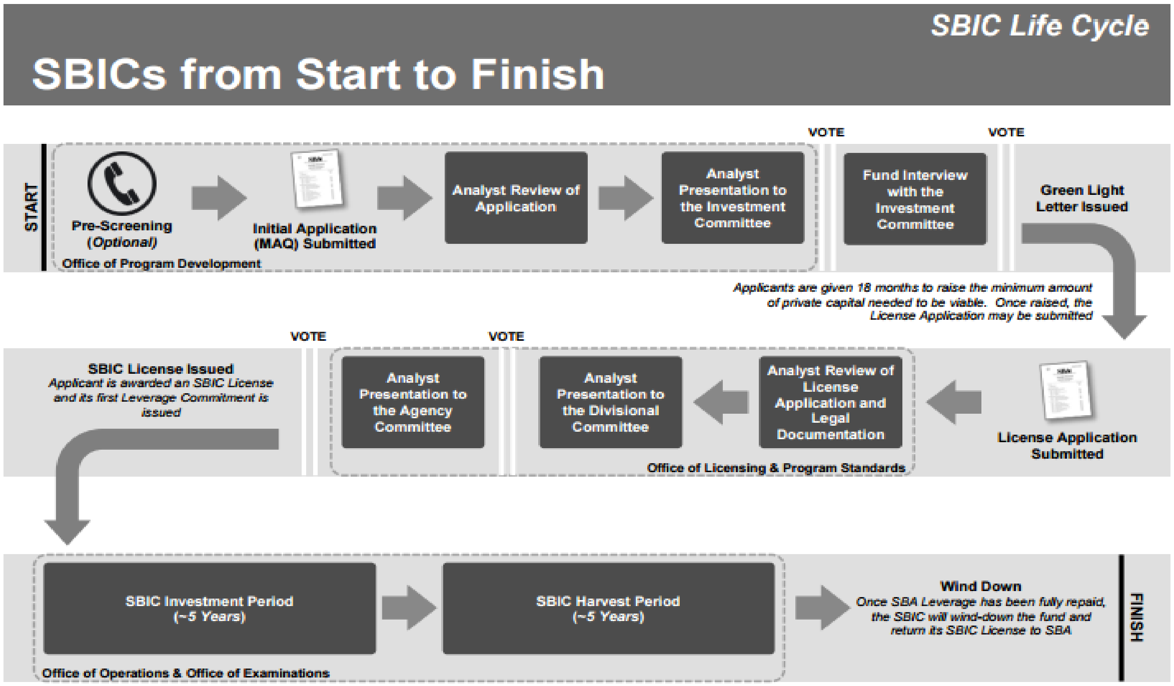
Rigorous Licensing Process

SBA uses a two-step licensing process for first time SBICs. In the first phase, an applicant completes and submits to SBA a form called a "Management Assessment Questionnaire ("***MAQ***"). This contains the elements of the applicant's business plan, as well as detailed information concerning the experience of each member of the team that will implement that business plan. SBA requires a minimum of two, substantially full time members of the management team, each with not less than five years of successful private investment experience at a decision-making level in the types of investments that the applicant proposes to make as an SBIC. The track record of successful applicants generally includes at least 10-15 investments with a reasonable number of completed realizations. SBA also considers how long and in what ways the management group has worked together. SBA views the track records of the managers and the cohesiveness of the management team of fundamental importance. No management team can be dominated by a single individual. The MAQ is reviewed by SBA's Investment Committee and, if the applicant appears qualified, the management team will be invited to SBA for an interview. After the interview, the applicant is either turned down or invited to file a formal application. The MAQ vetting process currently results in more than one-half of the initial applicants being turned down.

The formal license application contains additional information about the applicant and its management team, as well as organizational documents of applicant and its manager (usually a general partner). That application cannot be filed unless the applicant is able to show that it has subscriptions and commitments from private investors of at least $15-20 million. An applicant must meet a diversity test between management and other investors and there must usually be at least three other investors investing at least 30% of the applicant's private capital.

SBA seeks to determine that that there is a quality management team that has a good chance of operating profitably and with the experience and capability to operate within the strict regulatory framework applicable to SBICs. The SBA examines the prospective SBIC management team for relevant investment experience; a realized track record of superior returns; a cohesive and strong management team culture; and an ability to manage cash flow to provide the assurance that the SBA Leverage will be repaid.

In addition to an exhaustive review of the team's track record, the SBA conducts a credit report and reference checks on each member of the team. An FBI background check is run on each to probe into any possible criminal histories. Lawsuits involving the management team members and their funds are examined. The SBA makes phone calls to check relationships with former investors, portfolio company officers, colleagues, and friends of each team member to determine the character of the team member, deal attribution, and verification of statements made in the application. Generally, this SBA review of the application takes a minimum of four months, but usually at least six. SBA's Office of General Counsel reviews the applicant's and its manager's organizational documents. Each side letter agreement between an applicant, its manager, and any investor of the applicant requires prior SBA approval. SBA requires that counsel to the applicant provide opinions to SBA covering formation, securities, and partnership tax issues. After the review is completed, a report and recommendation is made to SBA's Divisional Licensing Committee. If that Committee approves, the application is then reviewed by SBA's Agency Licensing Committee, consisting of SBA's most senior personnel. If the Agency Committee approves, the license is sent to the SBA Administrator for signature.



SBIC Regulations Class

All prospective team members of an SBIC licensee are required to attend a class on SBIC regulations conducted by SBA prior to the license being granted. The training class is a day-long session in Washington, D.C., intended to provide fund managers with an understanding of and insight into important SBIC regulations. Some of the topics covered at the training class include: 1) conflicts of interest rules for SBICs; 2) the types of companies in which an SBIC can invest and the types of businesses in which an SBIC is prohibited from investing; 3) the investment rules applicable to an SBIC, for example, the "cost of money" regulation which caps the amount of interest and other charges, control rules, and how idle funds must be invested; 4) reporting requirements, including portfolio valuation reports and capital certifications; 5) the annual SBA examination process and fees; and 6) distribution rules applicable to SBICs.

Office of SBIC Operations

Once licensed, SBA oversight continues to ensure that the SBIC operates within the regulatory framework and does not put at risk repayment of the Leverage that the SBIC draws. Each SBIC is assigned an SBA analyst and an SBA area chief. These SBA personnel have oversight responsibility by interacting with the SBIC, monitoring it, and reviewing its portfolio and reports. For the 300 SBICs in the program, there are approximately 13 analysts at the SBA, each assigned to approximately 23 SBICs. Analysts are responsible for collecting and analyzing reports from their SBICs, reviewing any potential regulatory violations, and providing assistance to SBICs to help in understanding and complying with the regulations. An SBIC usually meets once a year in person with its analyst to review the SBIC's financial performance and regulatory compliance history.

SBIC Recordkeeping Requirements

SBICs must establish and maintain accounting records using SBA's standard chart of accounts for licensees. SBICs must keep on-site all accounting and other financial records; all minutes of meetings of directors, stockholders, executive committees, partners, or other officials; and all documents and supporting materials related to its business transactions, except for any items held by a custodian. All documents must be preserved in accordance with statutory and regulatory guidelines.[6]

SBIC Reporting Requirements

The reporting process allows the SBA to ensure SBICs are complying with the comprehensive regulatory and financial responsibilities. Below are the major reporting requirements for SBICs:

- Requirement for Licensees to file financial statements with SBA (Form 468) – Once licensed, each SBIC is required to file with the SBA an annual financial report which includes an audit by an SBA-approved independent public accountant. Form 468 must be prepared in accordance with SBA's Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies.[7]
- Requirement to file portfolio financing reports (SBA Form 1031) – SBICs are required to file a portfolio financing report within 30 days of the closing date for each financing of a small business.[8]
- Requirement to report portfolio valuations to the SBA – SBICs are required to file the value of its loans and investments within 90 days of the end of the fiscal year in the case of annual valuations and within 30 days following the close of other reporting periods. SBICs must also report any material adverse changes in valuations at least quarterly (within 30 days following the close of the quarter).[9] Valuations of an SBIC's portfolio companies must be in accordance with required SBA valuation guidelines.
- Other items required to be filed by licensee with SBA – SBICs are required to file copies of reports provided to investors, documents filed with the Securities and Exchange Commission, and documents pertaining to litigation or other legal proceedings, including criminal charges against any person who was required by the SBA to complete a personal history statement in connection with the SBIC's license.[10]
- A Capital Certificate is filed from time to time as the SBIC draws funds from its investors. These certificates permit SBA to monitor the SBIC's "Regulatory Capital," a fundamental concept in ensuring the SBIC is not capitally impaired[11], is charging a

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[6] 13 CFR Section 107.600
[7] 13 CFR Section 107.630
[8] 13 CFR Section 107.640
[9] 13 CFR Section 107.650
[10] 13 CFR Section 107.660
[11] 13 CFR Sections 107.1830-1850

management fee within SBA guidelines[12], and investments in any one portfolio and its affiliates do not exceed the permitted limits.[13]

SBIC Examinations

SBA examinations are regulatory compliance audits. [14] While required by law to be performed at least every two years, in practice, they are performed much more frequently. During Fiscal Year 2013, audits of SBICs using Leverage were conducted every 11.6 months and audits for non-leveraged funds (no credit risk to the U.S. Government) were conducted every 16.5 months. Examiners look to see that the SBICs' investments were made in accordance with the regulations. If not, the examiner makes a "finding" which is then forwarded to the Office of Operations. That Office reviews the exam report and the "finding" and determines if a violation has occurred. Oftentimes, the finding/violation is resolved by changing the terms of the investment to remove the offending term. The SBA assesses fees for the examinations.[15] A base fee is assessed based on the total assets of the SBIC and adjustments to the base fee are made if the SBIC has no outstanding regulatory violations at the time of the exam.

SBIC Conflicts of Interest Rules

Since 1958, the SBIC Office of Operations ensures that SBICs comply with applicable conflict of interest rules.[16] If an SBIC is found in violation of any conflict of interest rule, a number of options are available: the fund can disinvest; the fund can change the terms of the investment to address the conflict issue; additional leverage could be denied; or the fund could potentially be transferred to liquidation. Below are examples of some of the conflict of interest rules governing SBICs:

- SBICs may not provide financing to an "associate." The precise definition of an associate of an SBIC is defined in Section 107.50. It includes: a) an officer, director, employee, or agent of a Corporate Licensee; b) a control person, employee, or agent of a partnership licensee; c) an investment adviser/manager of any licensee, including any person who contracts with a control person of a partnership licensee to be the investment adviser/manager of such licensee; d) any person regularly serving a licensee on retainer in the capacity of attorney at law; or e) any person who owns or controls at least 10 percent of any class of stock of a licensee.
- SBICs may not finance the associate of another SBIC while the other SBIC finances the first SBIC's associate.
- SBICs may not borrow from a portfolio company, any of its officers, directors, or owners, or their close relatives.

[12] 13 CFR Section 107.510
[13] 13 CFR Section 107.740
[14] 13CFR Section 107.690
[15] 13 CFR Section 107.692
[16] 13 CFR Section 107.730

- SBICs may not provide financing to a small business for the purpose of discharging an obligation to the SBIC's associate or to free other funds for that purpose.
- SBICs may not provide financing to a small business for the purpose of purchasing property from the SBIC's associate.
- Co-investing with associates generally requires prior SBA approval to demonstrate that the terms and conditions are fair and equitable to the SBIC.
- SBA approval is needed to designate an associate to serve as an officer or director of a portfolio company if the associate has more than a five percent equity interest in the portfolio company.
- An SBIC cannot self-deal to the prejudice of a small business in which the SBIC has invested, the SBIC, the SBIC's owners, or SBA.

Other SBIC Rules

The SBIC regulatory regime includes:

- Required certifications for each portfolio company financing that the SBIC enters into – SBICs must file the Size Status Declaration (Form 480) to certify that the small business fits within the SBA small business size standard; SBA Form 652 to certify the small business will not illegally discriminate; Form 1031(see SBIC Regulatory Requirements above); and certifications that the investment qualifies for use of specialized debenture Leverage, either LMI (low and moderate income) debentures or energy saving debentures. [17]
- Requirements to obtain information from portfolio concerns – SBICs are required to obtain information for initial financing decisions, including the financial statements, plans of operation, cash flow analyses, and other documents necessary to make the investment decision.[18]
- Changes in ownership, control, or structure of licensee – SBICs must get prior approval from the SBA for certain changes in the structure of the SBIC. These requirements are detailed in Section 107.400 – 107.475.
- Portfolio concentration limits (overline) – The current portfolio concentration limits place a 10% cap of the total capital in any single portfolio company. If an overline violation occurs, the fund will work with the SBA to take action by reducing its investment or disinvest in the portfolio company.[19]
- Terms of investment (maturities, rates, amortization, fees) – When making investments in small businesses, the financing terms must comply with applicable SBA investment regulations. Any investment in a small business must be for a minimum of one year and must be no longer than 20 years.[20] The maximum rate of amortization on loans and debt securities cannot be amortized faster than straight line for the first year. The small

[17] CFR Section 107.610
[18] CFR Section 107.620
[19] CFR Section 107.740
[20] CFR Section 107.830 and Section 107.840

business cannot be required to redeem equity securities earlier than one year from the date of closing unless it meets certain conditions, and the redemption price for equity security investments must conform to specified rules.[21] The SBA defines "cost of money" as the interest rate ceiling and limitations on fees charged to small businesses. These regulations are designed to protect the small businesses from overreaching.[22]

- Any transfer of an ownership interest in an SBIC requires pre-approval by SBA.
- SBICs generally must clear any distribution made to its owners with SBA. Generally, SBICs can distribute net profits, but cannot reduce capital more than 2% in any year without prior SBA approval.[23]
- No new manager or officer of an SBIC may be appointed without prior SBA approval.[24]
- The organization documents of the SBIC and its manager cannot be amended without the prior consent of SBA.
- SBICs that draw Leverage cannot enter into secured lending arrangements with third parties.[25]
- A change of control of an SBIC requires prior SBA approval.[26]
- There are restrictions on common ownership and control of two or more SBICs, absent SBA approval.[27]
- SBA must approve the management agreement and the management fee that an SBIC with Leverage can pay and sets a cap on that fee.[28]
- SBA restricts the categories of expenses that the SBIC can pay.[29]

Referrals to the Office of Inspector General (OIG)

If any person believes an SBIC has operated outside the law, that person can refer the situation to the OIG. Portfolio companies are able to make these referrals. If the referral is made by a person outside the SBA, it is usually made directly to the Office of Inspector General. In many instances, a disgruntled portfolio company executive not happy with the decisions made by the SBIC raises the issue. Referrals from within the SBA are generally substantive. As a result of such referrals, some SBICs have had licenses revoked and their principals have faced criminal charges. In other instances, applications have been withdrawn due to inaccurate statements made by a principal.

SBIC Office of Liquidations

[21] 13 CFR Section 107.850
[22] 13 CFR Section 107.855, Section 107.860, and Section 107.900
[23] 13 CFR Sections 107.1500-1590
[24] 13 CFR Section 107.160
[25] 13 CFR Sections 107.550-570
[26] 13 CFR Sections 107.400-430
[27] 13 CFR Section 107.460
[28] 13 CFR Section 107.510
[29] 13 CFR Section 107.520

SBICs that fail to comply with regulatory requirements, depending upon the seriousness of the violation, can be transferred to the Office of Liquidation. For an SBIC so transferred, SBA oversees the wind down and liquidation of the fund. A management-led wind down can be undertaken under SBA oversight if SBA determines that it is reasonably likely that SBA will fully recover all amounts owed to it (including repayment of Leverage) and there has not been any management malfeasance. Existing management remains in place, often with a reduced management fee, and an SBA-approved wind up plan must be followed. SBA also has the power to put an SBIC into court-supervised receivership. This alternative is often used where SBA believes that management should be removed, SBA perceives the likelihood of losses, and/or where suspicion exists of management malfeasance.

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