
PEPPER HAMILTON LLP

**AN OVERVIEW OF THE
SMALL BUSINESS INVESTMENT COMPANY PROGRAM**

Michael B. Staebler, Esq.
E-Mail: staeblerm@pepperlaw.com

*Suite 3600
100 Renaissance Center
Detroit, Michigan 48243-1157
313-393-7394 (direct)
313-259-7110 (general)
313-259-7926 (fax)*

*600 14th Street, N.W.
Washington, DC 20005-2004
202-220-1432 (direct)
202-220-1200 (general)
202-220-1665 (fax)*

WWW.PEPPERLAW.COM

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THE SBIC PROGRAM

A Small Business Investment Company (“SBIC”) is a privately owned and operated company that makes long-term investments in American small businesses and is licensed by the United States Small Business Administration (“SBA”).

The principal reason for a firm to become licensed as an SBIC is access to financing (“Leverage”) provided by SBA. In addition, banks and Federal savings associations (as well as their holding companies) owning or investing in SBICs have the ability to own indirectly more than 5% of the voting stock of a small business. Banks, Federal savings associations and their holding companies also receive Community Reinvestment Act Credit for SBIC investments; and, in the case of banks and their holding companies, also receive exemptions from certain capital charge regulations and lending “affiliation” rules under the Gramm-Leach-Bliley Act.

This document provides a summary description of SBA Leverage and a general overview of other SBA regulations and policies.

The U.S. Small Business Administration

The SBA administers the SBIC Program through its Investment Division (which employs approximately 80 people). SBA is an independent Federal agency. SBA is located at 409 Third Street SW, Washington DC 20006, 202.205.6510. Useful information about the SBIC Program is available on SBA’s website at www.sba.gov/INV or may be obtained by contacting Ms. Margaret Dennin (202.205.6234) or Ms. Kristi Craig (202.205.7546).

NASBIC

The SBIC industry is served by an active trade association, the National Association of Small Business Investment Companies (“NASBIC”), which is located at 1100 H St. NW, Suite 610, Washington DC 20005 (202.628.5055), www.nasbic.org. NASBIC’s President is Mr. Brett Palmer. NASBIC provides a variety of information and services to its members and represents the industry with SBA and on Capitol Hill. NASBIC publishes a regular newsletter and is a resource for information concerning the SBIC Program.

Historical Perspective

Established by the United States Congress in 1958 to stimulate long-term investment in American small businesses, the SBIC Program has evolved into a significant factor in financing smaller American businesses. Over the years, SBICs have provided \$56 billion of funding to more than 107,000 businesses, including well-known companies such as Apple Computer, Federal Express, Cray Computers, Callaway Golf and Outback Steakhouse.

The SBIC Program has undergone significant changes since its creation in 1958. During the 1960s, more than 1,000 SBICs were in operation, a number of which specialized in real estate activities. Many of these were capitalized with the minimum private capital (initially \$150,000) and were managed by people without significant prior venture capital experience. Many of these early SBICs were commercially unsuccessful and most were short lived. During the 1970s, the 300-500 operating SBICs showed considerably more investment expertise, and the SBIC Program played the leading role in the venture capital industry. During the 1980s, extremely high interest rates (that later fell) accentuated the structural problem of making long-term equity investments using current-pay Debentures as a financing source. In addition, other regulatory features of the SBIC Program (such as total Leverage being limited to \$35 million which encouraged small private capitalization (\$12 million being required to use all the Leverage) which in turn led to investments in very small businesses), coupled with the rise of large venture capital firms and the emergence of pension funds and endowments as significant providers of capital to the venture industry (which for Federal tax reasons were discouraged from investing in SBICs using Debentures), caused the SBIC industry to decline during the 1980s. By the early 1990s, only 180 SBICs continued in operation, of which approximately 80 did not use Leverage and were owned by banks.

In 1991, SBA appointed an Advisory Commission that reviewed the SBIC industry's performance, determined that it had a significant role to play in building the U.S. economy, and outlined significant program changes required to make the program successful. The principal features of the Advisory Commission's report were embodied in legislation known as the "Small Business Equity Enhancement Act of 1992" (the "1992 Act"). The 1992 Act drastically changed the SBIC Program. It created a new form of SBA Leverage known as "Participating Securities" (preferred limited partnership interests); increased the amount of Leverage available to an SBIC to \$90 million (which subsequently was indexed to reflect changes in the cost of living since March 31, 1993 and then modified in 2009 to be \$150 million); required minimum private capital of \$10 million for SBICs using Participating Securities and \$5 million for SBICs using Debentures; provided for stricter SBA licensing standards; and proposed other changes to make the program more consistent with the private venture capital industry. Regulations implementing the 1992 Act became effective on April 25, 1994. The Act and regulations have undergone several revisions since 1994 that have further streamlined and improved the program.

From the summer of 1994 through September 30, 2009, 467 SBICs were licensed. As of October 1, 2009¹, there were 127 SBICs using Participating Securities with aggregate private capital of \$3.362 billion and 126 SBICs using Debentures, with aggregate private capital of \$3.402 billion. There also were 48 unleveraged (including bank owned) SBICs with private capital of \$1.796 billion and 14 "specialized" SBICs (investing in businesses owned by socially or economically disadvantaged persons) with \$91 million of private capital.

¹ SBICs that have surrendered their licenses or have been transferred to the Office of Liquidation are not included in these figures.

In the fiscal year ended September 30, 2009, SBA licensed a total of 11 SBICs as follows: 8 Debenture and 3 unleveraged SBICs; and SBICs invested \$1.856 billion in 1,481 companies.

“Termination” of the Participating Securities Program

Following the burst of the “technology bubble” in 2002, the Administration decided there no longer was a need for an equity SBIC program and that the existing Participating Securities Program would cause significant losses to SBA. The decision also reflected a broader Administration policy that the government should not participate in financing equity investments. Accordingly, SBA decided to terminate the Participating Securities Program and announced that beginning October 1, 2004, it neither would issue new commitments to use Participating Securities nor license new SBICs that planned to use Participating Securities. SBA continued to honor existing commitments for Participating Securities the last of which expired on September 30, 2008. SBIC industry officials disagree with SBA’s position with respect to the equity program and have continued to work with Congress in an effort to devise an acceptable replacement for the Participating Securities Program.

Continuation of Debenture Program

SBA officials continue to emphasize that they believe the Debenture Program is working well and they expect it to continue. SBA is actively seeking new applicants for the Debenture Program.

SBA Leverage

SBA currently provides financing (called “Leverage”) to SBICs in the form of “Debentures”. Debentures are unsecured loans issued by the SBIC that have interest only payable semi-annually and a ten-year maturity. The interest rate is established when issued, and most recently has been approximately 76 basis points in excess of the interest rate on Treasury Notes with 10-year maturities (the “Treasury Note Rate”).

As of October 1, 2009, there were \$4.024 billion in outstanding Participating Securities. Participating Securities are preferred limited partnership interests that are redeemable after 10 years and which provide SBA with both (i) a current return (which SBA calls a “Prioritized Payment”) established when Participating Securities are issued, which generally ranged from 250 to 356 basis points over the Treasury Note Rate, and is contingent upon and payable only from cumulative realized partnership profits, and (ii) a modest share of the Partnership’s profits (typically from 6% to 7%). No new Participating Securities have been issued since September 30, 2008.

In addition, SBA has created “LMI Debentures” for use by SBICs making investments in Low and Moderate Income Zones (“LMI Zones”) that are more fully described

below under the heading “LMI Investments.” A limited amount of LMI Debentures has been issued.

Requesting Leverage

SBICs obtain Leverage by obtaining a “Leverage Commitment” and then drawing down Leverage from the Commitment. Leverage Commitments may be obtained at the time of licensing for an amount up to one tier² of Leverage (subject to availability) and as needed thereafter. When a Leverage Commitment is issued, the SBIC pays a “one time” commitment fee that is 1% of the amount of the Commitment.. Commitments expire on September 30 of the fourth Federal fiscal year following the fiscal year of their issuance.

SBICs may draw down committed Leverage on one day’s notice through an interim credit facility provided by the Federal Home Loan Bank of Chicago. At the time of each disbursement fees totaling 2.425% are deducted from the amount the SBIC receives (a 2% “user” fee payable to SBA, 37.5 basis points of underwriting fees and 5 basis points as an administrative fee to the Selling Agent).³The SBIC pays an interim interest rate on Debenture Leverage of LIBOR plus 30 basis points and the amount of SBA’s “Fee” described below. Every six months, all interim Leverage is pooled by SBA and a new interest rate for Debentures is established which is then fixed until the Leverage is repaid. Debentures are pooled in March and September of each year.

SBA only will issue “one-half tier” of Leverage to a newly licensed SBIC before SBA conducts its first regulatory examination (6-10 months after licensure).

Typical Use of Leverage

Once a management team files its formal SBIC application,⁴ it may hold a closing, form its fund and begin operations. However, it may not obtain Leverage until it receives its license, a process that historically usually has taken from 6-10 months. During this interim period most applicants draw their private capital to pay organization expenses, management fees and make investments. In any event, they are required to have drawn at least \$2.5 million of private investors’ capital prior to licensing. Once licensed, most SBICs fund their operations solely by using SBA Leverage until the ratio of outstanding Leverage to paid-in capital from private investors (called “Leverageable Capital”) reaches two-to-one, and they then

² A “tier” is SBA jargon for the amount of an SBIC’s Regulatory Capital (paid-in capital plus unfunded commitments from investors having sufficient financial means to qualify as “Institutional Investors”). SBA permits well performing Debenture SBICs with seasoned portfolios to use a “third tier” of Leverage in certain circumstances. See the section below entitled “Just in Time Financing”.

³ Prior to February 2006 the underwriter’s fee was 50 basis points.

⁴ See the section below entitled “Licensing”.

coordinate capital calls from private investors with the use of Leverage to maintain a two-to-one Leverage ratio.⁵ SBICs are permitted to borrow money from banks or other unaffiliated third parties prior to their initial Leverage draw which SBA requires to be repaid when Leverage is first drawn.

Leverage Availability

The stimulus legislation enacted in 2009 increased available Leverage for a single SBIC to \$150 million and Leverage for a group of commonly managed SBICs to an aggregate of \$225 million. Prior to the stimulus legislation, for the fiscal year ending September 30, 2009, SBA Regulations provided that the maximum amount of Leverage available to an SBIC (or a group of commonly controlled SBICs) was \$137.1 million (\$90 million indexed for increases in the Consumer Price Index after March 31, 1993). The amount of Leverage available to a particular SBIC is limited to a multiple of its paid-in private capital..⁶

SBA obtains funds enabling it to supply Leverage by guarantying payment of Trust Certificates that are purchased by traditional purchasers of government-guaranteed notes. SBA then invests the proceeds in SBICs in the form of Debentures (or, prior to October 1, 2008, in the form of Participating securities). SBA Guaranteed Trust Certificates are sold for Debentures in March and September of each year.

The amount of Debentures that may be issued each year is subject to the amount authorized by Congress. In recent years, Congress has enacted authorized levels in three-year cycles. For the fiscal year ending September 30, 2010, \$3 billion of Debentures is available. At least a similar amount is expected to be available in 2011.

Trust Certificates are sold with the assistance of investment bankers (who receive a 37.5 basis point fee) to institutional purchasers of government-guaranteed, fixed rate notes with 10-year maturities. The purchasers require a premium over the interest rate on Treasury Notes with 10-year maturities. The amount of this premium fluctuates with economic conditions at the time the notes are sold. The premium over the 10-year Treasury Note rate was 1.035% for the \$238.295 million Debenture pooling in September 2007, but in reaction to the professed desire to invest in more liquid securities by the traditional purchases, the premium rose to 2.078% in

⁵ SBA policies, however, require that an SBIC must have invested in portfolio companies at least 50% of the Private Capital that it had drawn prior to receipt of Leverage. Some SBICs that have incurred sizeable organization expenses and/or management fees prior to making investments have found it necessary to draw more than \$2.5 million of Private Capital in order to comply with this policy. Additionally, Debenture funds may draw at a three-to-one ratio in certain circumstances.

⁶ In addition, the New Markets Venture Capital Program Act of 2000 provides that the Leverage ceiling for an SBIC will be calculated without regard to the amount of the cost basis of equity investments made by the SBIC in a “Smaller Enterprise” located in a “low income geographic area” (but only to the extent that such amounts do not exceed 50% of the SBIC’s “Regulatory Capital”). However, SBA has not administratively implemented these provisions.

March 2008 and to 2.273% in the \$360.745 million pooling in September 2008. In the March 2009 pooling the premium declined to 1.68%, and declined further to 0.765% in the September 2009 pooling, and to the historically low level of 0.47% in the March 2010 pooling.

Historically, the amount of Participating Securities and Debentures that could be issued each year was subject to annual Congressional appropriation of an amount necessary to cover anticipated losses on the Leverage issued. Thus, the amount of Congressional appropriation and the rate of loss anticipated on the issued Leverage (referred to as the “Subsidy Rate”) determined the actual amount of available Leverage each year that typically was significantly less than the level “authorized” by Congress. Beginning on September 1, 1996, SBA charged a 1.00% annual “Charge” on Leverage it provided to SBICs, causing significant reductions in required Congressional appropriations needed to support increasing amounts of available Leverage. The amount of the “Charge” is determined in the fiscal year in which a Leverage Commitment is issued and applies to all Leverage issued pursuant to that Commitment. The Subsidy Rate was substantially reduced in the case of Debentures, to less than 1.00% with the result that no appropriations were required to support their issuance beginning in FY 2000.

In December 2000 legislation was enacted requiring SBA to set the amount of the Charge it imposed on Commitments issued each fiscal year at the rate necessary so that the sum of all fees charged (including 1% commitment fees, 2% user fees, the annual “Charge” and anticipated profit distributions) would equal the amount of anticipated losses. The Charge for Debenture Commitments issued in FY 2007 was approximately 0.91%, and was 0.72% in FY 2008. The Charge declined to 0.41% for FY 2009 and to 0.285% for 2010.

As a point of reference, the amounts of Leverage available since FY 1995 have been as follows:

	<u>PARTICIPATING SECURITIES</u>	<u>DEBENTURES</u>
FY 1995	\$229 million	\$109 million
FY 1996	\$267 million	\$110 million
FY 1997	\$410 million	\$376 million
FY 1998	\$700 million	\$600 million
FY 1999	\$1.150 billion	\$700 million
FY 2000	\$1.368 billion	\$800 million
FY 2001	\$2.000 billion	\$1.00 billion
FY 2002	\$3.500 billion	\$2.50 billion
FY 2003	\$4.000 billion	\$3.00 billion
FY 2004	\$4.000 billion	\$3.00 billion
FY 2005	N/A	\$3.00 billion
FY 2006	N/A	\$3.00 billion
FY 2007	N/A	\$3.00 billion
FY 2008	N/A	\$3.00 billion
FY 2009	N/A	\$3.00 billion

FY 2010

N/A

\$3.00 billion

SBA's website (www.sba.gov/INV) contains historical information concerning the amount and pricing of Leverage committed and issued since the SBIC Program was restructured in 1994.

**Summary of Calculation of Interest Rate Charged on
Debentures and Prioritized Payment Rate on Participating Securities**

The rate of interest payable by an SBIC on Debentures and the Prioritized Payment rate⁷ on Participating Securities is the sum of the following:

1. The interest rate of Treasury Notes with 10-year maturities at the time the Trust Certificates are pooled and sold;
2. The premium required by the purchasers of the Trust Certificates above the 10-year Treasury Note Rate; and
3. The annual Charge payable to SBA at the rate applicable in the fiscal year in which the Commitment was issued.

Thus, for example, the interest rate for **Debentures** issued in September 2009 pursuant to a commitment issued during FY 2008 was:

3.468%	10 Year Treasury Rate
0.765%	Premium required by Trust Certificate purchasers
<u>0.720%</u>	SBA Charge fixed in FY 2008
4.953%	Total Interest Rate

⁷ SBA refers to the sum of 1 and 2 as the Trust Certificate Rate or the Prioritized Payment rate to which an annual Charge is added. For simplicity's sake, references to the Prioritized Payment Rate in this memorandum also includes the "Charge".

Similarly, for example, the Prioritized Payment rate for **Participating Securities** issued in August 2008 pursuant to a commitment issued during FY 2004 was:

3.846%	10 Year Treasury Rate
2.098	Premium required by Trust Certificate purchasers
<u>1.454%</u>	SBA Charge fixed in FY 2004
7.398%	Total Prioritized Payment Rate

Debenture Leverage

Debentures have 10-year maturities, are not amortized prior to maturity, and bear interest payable semi-annually at a rate that, for Debentures issued in March 2010 was 0.466% plus the applicable SBA Charge⁸ in excess of the Treasury Note Rate (which was 3.542%). Debentures are unsecured, and the General Partner of the SBIC is not personally liable for their repayment. Beginning with the September 2006 issuance, Debentures may be prepaid without penalty. Debentures issued before September 2006 may be prepaid with a 5% penalty in the first year that declines 1% per year (i.e., 5-4-3-2-1%) so that the Debentures may be prepaid without penalty beginning in the sixth year following issuance. Repayment of Debentures is subordinate to repayment of loans from non-Associate lenders up to the lesser of \$10 million or twice the amount of the SBIC's Regulatory Capital (i.e., its capital from private investors). SBA is able to issue Debentures with maturities shorter than 10 years, but has not done so since 1991. Historically, SBA has restricted use of the "third tier" of Debentures until the SBIC has demonstrated it is operating profitably.

Prior to October 2004, certain tax-exempt entities that invested in SBICs were subject to recognition of unrelated business taxable income ("UBTI") as a result of the issuance of Debentures. Tax legislation adopted in October 2004 exempts tax-exempt investors from UBTI that otherwise would be caused by the use of Debentures by SBICs licensed after enactment of the legislation, but only if no such tax-exempt investor owns more than 25% of the capital or profits interest of the SBIC and all tax-exempt investors own less than 50% of the capital and profits interest of the SBIC.

Distributions by Debenture SBICs

SBICs using Debentures may distribute their undistributed net realized, cumulative earnings less unrealized depreciation to investors. However, without SBA's prior consent (which SBA is unlikely to give), they may not reduce their capital to investors by more

⁸ Determined by the date of the commitment used to draw the Debentures.

than 2% in any fiscal year.⁹ After completion of their “investment periods,” SBICs are required to submit a “Wind-Up” plan to SBA indicating when and how the SBIC intends to liquidate its assets and repay SBA. SBA’s written guidelines for such plans indicate its principal concern is to assure repayment of outstanding Debentures. However, several SBICs that have performed well and previously have repaid some of their Debentures have been able to negotiate Wind-Up plans that enable them to make certain distributions returning capital to their investors prior to repaying all of their outstanding Debentures.

Participating Securities - Distributions to SBA

Participating Securities were issued in the form of preferred limited partnership interests pursuant to which SBA was admitted to the Partnership as a Preferred Limited Partner. As a Preferred Limited Partner, SBA is entitled to receive a preferred return (referred to by SBA as a “Prioritized Payment”) prior to any distributions of profits being made to private partners, and to a limited Profit Participation when distributions of profits are made to the private partners. The Prioritized Payment rate for Participating Securities issued in August 2008 was 2.098% over the Treasury Note Rate of 3.846% (compounded annually) plus the applicable SBA Charge. Prioritized Payments are contingent upon and only payable from the cumulative, realized profits of the partnership, if any¹⁰. Participating Securities (together with earned but unpaid Prioritized Payments) have priority in liquidation over other partnership interests. Participating Securities mature and are redeemable ten (10) years after their issuance.

The amount of SBA’s Profit Participation is determined by a formula with two variables: the applicable Treasury Note Rate, and the ratio of Participating Securities to the SBIC’s Leverageable Capital (i.e., private, paid-in capital). If more than one series of Participating Securities are issued, the rate changes and thereafter is based on the highest Leverage Ratio (but may decline if additional private capital is paid in). The Treasury Note Rate is adjusted for subsequent financings based on the weighted average of amounts of Participating Securities outstanding and the time periods involved. The following table illustrates the Profit Participation Rate at various Leverage Ratios and Treasury Note Rates.

⁹ This restriction on distributions may cause a “phantom income” issue when an SBIC using Debentures realizes income in a year that does not exceed the amount of prior cumulative net losses. Distribution of such “income” would reduce the amount of the SBIC’s Regulatory Capital and, therefore, is subject to the 2% limitation. While investors may have received the benefit of deductions for these losses in prior years (although use of such losses is severally restricted for individuals), they may incur phantom income in the year in which such profits arise. This restriction also may cause operating issues for SBICs whose limited partnership agreements restrict the reinvestment of realized investment proceeds.

¹⁰ Note that SBA regulations provide that the calculation of realized profits for the purpose of determining SBA’s entitlement to Prioritized Payments (but not tax distributions or Profit Participation Payments) are based on “Earmarked Profits” that are calculated without any deduction for “unrealized depreciation” of assets in the SBIC’s portfolio. SBA’s entitlement to tax distributions and Profit Participation Payments are payable from “Retained Earnings Available for Distribution” (“READ”) which equals “Earmarked Profits” less “unrealized depreciation”.

<u>Ratio of Participating Securities to Private Capital</u>	<u>10 Year Treasury Note Rate</u>						
	<u>3.0%</u>	<u>4.0%</u>	<u>5.0%</u>	<u>6.0%</u>	<u>7.0%</u>	<u>8.0%</u>	<u>9.0%</u>
0.50	1.69%	2.25%	2.81%	3.38%	3.94%	4.50%	5.06%
1.00	3.38%	4.5%	5.63%	6.75%	7.88%	9.00%	10.13%
1.50	3.94%	5.25%	6.57%	7.88%	9.19%	10.50%	11.81%
2.00	4.5%	6.00%	7.5%	9.00%	10.50%	12.00%	13.50%

After SBA's Prioritized Payments are distributed to SBA, profits may be distributed to the private partners and SBA pursuant to so-called "tax distributions" and "returns on capital". The SBIC's profits are computed after deducting the Prioritized Payment payable to SBA. "Tax distributions" may be made on a quarterly basis.

The amount of the "tax distribution" equals the SBIC's profits (after taking unrealized depreciation into account – the result being "Retained Earnings Available for Distribution", or "READ") multiplied by the sum of the highest individual or corporate Federal and state tax rate applicable to the type of income (capital gains or ordinary income) being distributed. However, the rate will be adjusted to reflect the deduction of state taxes on the Federal return. The tax rates used will be those of the state in which the principal office of the SBIC is located. SBA is entitled to share in each "tax distribution" in proportion to its Profit Participation Rate.

Once Prioritized Payments and "tax distributions" are made, an SBIC may distribute (during the year) and is obligated to distribute (annually) the remainder of its cumulative Retained Earnings Available for Distribution (subject to retention of funds to satisfy its working capital needs pursuant to an SBA regulation requiring maintenance of "liquidity", and with SBA approval, reasonable reserves to meet contingent liabilities and protect existing investments). SBA defines Retained Earnings Available for Distribution ("READ") as being the SBIC's net realized, cumulative earnings less unrealized depreciation on portfolio companies (but excluding unrealized appreciation). SBA's share of such distributions depends on its Leverage Ratio, as follows:

- i. If the Leverage Ratio is more than 200%, distributions must be made in the ratio of Leverageable Capital to Leverage.
- ii. If the Leverage Ratio is more than 100% but not more than 200%, distributions must be made in the ratio of one-to-one.
- iii. If the Leverage Ratio is 100% or less, SBA's share of a distribution equals its Profit Participation Rate.

Thus, if the Leverage Ratio is greater than one-to-one, SBA will receive one-half of the distributions from READ (exclusive of Prioritized Payments and tax distributions). To the extent such distributions exceed SBA's entitlement to Profit Participation Payments, the distribution will cause a redemption of outstanding Participating Securities.¹¹

SBA may restrict distributions if it determines that the value of an SBIC's assets is materially overstated.

Distributions of an SBIC's cumulative profits to SBA will be applied first to its accumulated Prioritized Payments, next to its Profit Participation, next as a redemption of Participating Securities, and finally as repayment of Debentures (if any are issued).

After payment of Prioritized Payments, "tax distributions" and "returns on capital", the partnership may return capital to its investors (including SBA) if it does not have Capital or Liquidity Impairment, will not cause Leverage in excess of permitted levels, or decrease the SBIC's minimum capital below its required minimum. Such distributions are commonly referred to as a "return of capital" and are made to SBA and the private investors in proportion to Leverageable Capital to Leverage.¹²

SBIC regulations provide that an SBIC may make in-kind distributions, but only if the securities distributed are "Distributable Securities", as defined by SBA Regulations, at the time of distribution. SBA regulations preclude using in-kind distributions for paying tax distributions. Gains or losses on the securities distributed will be imputed as if they had been sold, using the value of the securities as of the date of distribution. "Distributable Securities" are defined as being securities that SBA determines (with the advice of a third party expert in the marketing of securities):

1. Are saleable immediately without restriction under Federal and state securities laws (including sales under Rule 144);
2. Are listed and registered on a National Securities Exchange or for which quotation information is disseminated in the National Association of Securities Dealers Automated Quotation System; and
3. The quantity of which can be sold by SBA over a reasonable period of time without having an adverse impact on the price of the security.

¹¹ Note that such redemption causes an interesting regulatory and accounting issue as READ is used to redeem the SBA's partnership capital. SBA calls the amount of such redemptions "Phantom READ". When distributions are thereafter made of such Phantom READ they are required to be made in the same manner as a "return of capital" distribution in proportion to the Leverage Ratio and SBA does not receive a "second" Profit Payment.

¹² However, in determining the sharing proportion, the amount of Capital Impairment is deducted from Leverageable Capital.

Notwithstanding its regulations and approved limited partnership agreements, for more than a year, SBA has not permitted in-kind distributions to be made, but recently has permitted an in-kind distribution where the SBIC arranged for an underwriter to sell SBA's share and agreed to pay SBA the amount of the discount that was incurred from the distribution valuation.

Additionally, prior to the winding up of the Partnership, the SBIC Act does not authorize an SBIC to prepay outstanding Participating Securities except as part of the integrated distributions described above unless the SBIC has adopted a plan of liquidation or the SBIC is placed in "Restricted Operations" pursuant to certain regulatory violations..

SBA regulations provide that once a distribution is characterized as a Prioritized Payment, a "tax distribution" or a "return on capital", it may not be recharacterized as a "return of capital" if the Partnership subsequently proves unprofitable. This might cause SBA to receive distributions early in the life of the Partnership that are characterized as profits even though the partnership ultimately proves to be unprofitable, and, in addition, receive return of the full amount of its Participating Securities in priority to return of the private investors' capital.

Repayment of Participating Securities (the outstanding principal balance plus any earned but unpaid Prioritized Payments or Profit Participation Payments) will have priority over repayment of capital to private investors upon the liquidation and winding up of the SBIC. If an SBIC has insufficient assets to pay these amounts to SBA, SBA may require it to call any remaining unpaid capital commitments from its private investors to the extent necessary to cause repayment to SBA. Because of this liquidation preference, operating expenses and realized losses of an SBIC are allocated first to the private investors and not to SBA. This has the effect of magnifying the private investor's reported losses during periods when an SBIC does not have cumulative net realized gains.

PARTICIPATING SECURITIES DISTRIBUTION EXAMPLE

The following example illustrates how Participating Securities distribution regulations work.

Assumptions

- Ratio of SBA Leverage to investor capital is 2:1
- Accumulated contingent Prioritized Payment is \$200,000 at time of distribution
- Combined Federal and state income tax rate is 40%
- 10 Year Treasury Note Rate of 6%; Prioritized Payment Rate of 8.55%
- SBA Profit Participation Rate of 9%
- \$2,000,000 to be distributed of which \$1,000,000 is Retained Earnings Available for Distribution, and \$1,000,000 is a Return of Capital

**Distribution of Retained
Earnings Available for Distribution**

\$1,000,000	Earnings before Prioritized Payment and taxes
<u>(\$ 200,000)</u>	8.55% Accumulated Prioritized Payment
\$ 800,000	Earnings available for distribution
<u>(\$ 320,000)</u>	Total Tax Distribution (40% tax rate)
	SBA \$ 28,800 (9.0 %)
	Investors <u>291,200</u> <u>(91.0 %)</u>
	<u>\$320,000</u> (100.00%)
\$ 480,000	Amount available for profit distribution and SBA Leverage redemption
<u>(\$ 240,000)</u>	SBA (50%)
	Profit distribution
	(\$480,000 x 9%) \$ 43,200
	Leverage redemption
	(\$240,000 - \$43,200) <u>\$196,800</u>
	<u>\$240,000</u>
<u>(\$ 240,000)</u>	Private Partners (50%)
\$ 0	

Distribution of Capital

\$1,000,000	Return of Capital
<u>(\$ 666,667)</u>	SBA – Leverage Redemption ¹³
<u>(\$ 333,333)</u>	Private Partners
\$ 0	

¹³ The actual amount distributed to SBA will be slightly less since the leverage rates will be less than 2:1 following the \$196,800 redemption of Participating Securities; and amounts to be distributed to the private partners will be approximately increased.

SUMMARY

Distribution to SBA

\$ 200,000	Prioritized Payment
28,800	Tax Distribution
43,200	Profit Distribution
196,800	Leverage Redemption – Retained Earnings
<u>666,667</u>	Leverage Redemption – Return of Capital
\$1,135,467	Total Distribution
\$ 863,467	SBA Leverage Reduction

Distribution to Private Partners

\$ 291,200	Tax Distribution
240,000	Profit Distribution
<u>333,333</u>	Return of Capital
\$ 864,533	Total Distributions – Allocated between General and Limited Partners as provided in the Partnership Agreement

Amounts distributed to the “Investors” in the illustration outlined above are distributable to the General Partner and Limited Partners of the SBIC as they privately agree and provide in the SBIC’s Limited Partnership Agreement. Thus, the payment of a “preferred return” to investors, a “carried interest” to the General Partner, or the timing of any “tax distributions” to the private partners is determined by the terms of the Partnership Agreement and not SBA Regulations.

The distribution example set forth above would generally not be typical of the first distribution made by an SBIC to its Partners. Typically, an SBIC accrues losses for several years from accumulating management fees, amortized organization costs and other miscellaneous operating expenses. These expenses usually amount to several million dollars before sufficient profits are realized which would entitle SBA to receive Prioritized Payments, “tax distributions” or Profit Participation Payments. Thus, the first realized profits generally will be distributed as if they were a “return of capital” until realized profits exceed accumulated losses. Then, the next amount of realized profits are distributed to SBA until it has received the full amount of accumulated Prioritized Payments. Next, “tax distributions” and Profit Participation Payments will be distributed to the extent of READ. Finally, additional “return of capital” distributions may be made.

Just in Time Financing

The SBIC Program permits the funds of investors and SBA Leverage to be taken down by the Partnership in “lock step”, thereby delaying investor capital calls and increasing investor returns. An SBIC using Debentures is required to have total “Regulatory Capital” (paid-in capital plus unfunded binding commitments from “Institutional Investors”) of at least \$5 million. However, in the past year SBA has required SBICs to have firm commitments when their formal license application is filed for an amount of capital that is sufficient to enable them to have a first closing and conduct their operations even if they do not subsequently raise additional funds. While an applicant needs to have binding subscriptions for the full amount of its “Regulatory Capital” only \$2.5 million of the SBIC’s Regulatory Capital needs to be paid-in prior to issuance of the SBIC License. Once at least one-half of this \$2.5 million is invested, the SBIC will be eligible to use SBA Leverage prior to having another capital call from investors.

SBA regulations describe the qualifications of “Institutional Investors”. They can be most forms of business entities with a net worth of at least \$10 million, or banks or savings and loan associations or their holding companies, insurance companies, pension plans for private or public sector employees, and tax-exempt foundations or trusts, in each case with a net worth of at least \$1 million. Institutional Investors also include individuals with a net worth of at least \$10 million (exclusive of the equity of their most valuable residence) or \$2 million if the amount committed to the SBIC does not exceed 10% of their net worth. Not more than 33% of the SBIC’s private capital may be invested by government entities. If an Institutional Investor has a net worth of less than \$10 million, only that part of its unfunded commitment that is less than 10% of its net worth will be included in Regulatory Capital.

Unleveraged SBICs

SBICs not using Leverage (as is customary with most banks) are exempted from a number of SBA regulations. Most importantly, they may invest any amount of their private capital in a Small Business and are not restricted to investing an amount not exceeding 30% of their Regulatory Capital. Additionally, they have greater flexibility in investing their “idle funds” are not required to obtain prior approval of management expenses they incur (although they must notify SBA of them), may sell their assets to “Associates”, and are relieved from certain other record-keeping and reporting requirements. Prior to obtaining Leverage, an unleveraged SBIC must satisfy the regulations that apply to Leveraged SBICs.

LMI Debentures

On September 30, 1999, SBA adopted regulations providing incentives for SBICs to invest in Low and Moderate Income Zones (“LMI Zones”). Debenture SBICs also may use LMI Debentures. Highlights of the regulations are as follows:

1. An LMI Zone is a geographic area that satisfies one of five definitions that currently are used by different Federal agencies in determining areas requiring special attention.

2. SBICs making venture capital type investments (equity or certain subordinated loans) in small businesses with 50% or more of its employees or tangible assets in an LMI Zone, or to a small business that has 35% of its employees residing in an LMI Zone, will be eligible to obtain SBA financing in the form of a deferred interest Debenture. SBA intends to issue non-amortizing Debentures with maturities of 5 or 10 years, each with a “zero coupon” for the first 5 years. If the interest rate is 7%, this means that the SBIC would receive approximately \$71,000 in proceeds for issuing a \$100,000 Debenture. On the 10-year Debentures, interest would be payable semi-annually commencing in the 6th year.

3. The Small Business financed by the SBIC must either satisfy the employee or asset test described above at the time of applying to the SBIC for financing, or within 180 days after the closing of the financing.

4. LMI Debentures will be issuable to SBICs that have reserved Debenture Leverage. At the time of making a draw request, the SBIC will specify whether it will use an LMI Debenture or a regular Debenture. The interest rate for the LMI Debenture is fixed when it is initially issued for its full term. LMI Debentures will be held by the Federal Home Loan Bank of Chicago and are not pooled in the same manner as other Leverage.

Community Reinvestment Act Credit

Current Community Reinvestment Act (“CRA”) regulations present banks (other than certain “small banks”) with a continuing need to make investments that qualify for CRA purposes. Investment in an SBIC is specifically identified in the CRA regulations as a type of investment that will be presumed by the regulatory agencies to be a “qualified investment” for CRA purposes. The investment should be in an SBIC that is located in or doing substantial business in the region in which the bank’s assessment area is located, but the SBIC is not required to be headquartered within the assessment area itself. The SBIC Act and other Federal statutes explicitly permit banks, bank holding companies, Federal savings associations and savings and loan holding companies to invest in SBICs.

Gramm-Leach-Bliley Act Exemptions

As part of the implementation of the Gramm-Leach-Bliley Act (the “GLB Act”), effective April 1, 2002, the Federal Reserve Board, the FDIC and the Office of the Comptroller of the Currency adopted new regulations governing regulatory capital treatment for certain equity investments held by banks, bank holding companies and financial holding companies. Under the regulations, an 8% Tier 1 capital deduction applies on covered investments that in the aggregate are less than 15% of an organization’s Tier 1 capital, a 12% deduction applies to investments aggregating 15-24.99% of Tier 1 capital, and a 25% deduction applies to investments aggregating 25% and above of Tier 1 capital. The regulations exempt SBIC investments from such capital charges so long as their value is less than 15% of Tier 1 capital. However, the amount of SBIC investments will be considered when determining capital charges with respect to other investments.

In addition, ownership of a 15% equity interest in a portfolio company by a bank-affiliated SBIC will not give rise to a presumption that the portfolio company is an Affiliate under Sections 23(a) and (b) of the GLB Act.

SBIC Investments

An SBIC only may invest in “Small Businesses”, and must invest at least 25% of its invested funds in “Smaller Enterprises”¹⁴. SBA regulations define a Small Business as one with net worth (excluding goodwill) of less than \$18 million and average after-tax income (exclusive of loss carry-forwards) for the prior 2 years of less than \$6 million. Companies failing that test may still qualify if they meet certain size standards for their industry group which are based on the number of employees (typically 500 to 1,000 for a manufacturing company) or gross revenues. A “Smaller Enterprise” must have a net worth (excluding goodwill) of less than \$6 million and average after-tax income for the prior 2 years of less than \$2 million or must meet the alternative test. Certain debt-to-equity ratios must also be met if the Partnership finances the change of ownership of a Small Business with more than 500 employees.

SBIC regulations restrict the size of the investments that an SBIC may invest in any company and its affiliates (the so-called “over-line limit”). The Stimulus Legislation of 2009 changed the over-line limit from 20% of “Regulatory Capital” to 10% of the sum of Regulatory Capital multiplied by the leverage ratio approved at the time of licensing (i.e. 30% of Regulatory Capital if Regulatory Capital is fully leveraged with two tiers of Leverage). As a result of this change, if an SBIC receives private investments of \$20 million, it may not invest more than \$6 million in a single company without SBA’s approval (assuming it was approved for two tiers of Leverage at the time it was licensed as an SBIC.) SBA may approve a larger percentage if necessary to protect the SBIC’s investment, but has indicated it only will give such consent in unusual circumstances.

SBIC regulations preclude investment in the following types of businesses: companies whose principal business is re-lending or re-investing (venture capital firms, leasing companies, factors, banks); many kinds of real estate projects; single-purpose projects that are not continuing businesses; for use outside of the United States or have more than 49% of their tangible assets or employees outside the United States at the time of financing or within one year following the financing (unless the funding is used for a specific U.S. purpose that is acceptable to SBA); in businesses that are passive and do not carry on an active trade or business; and in businesses that use 50% or more of the funds to buy goods or services from an associated supplier.

Historically, SBA regulations prevented an SBIC (or two or more SBICs acting together) and its Associates (controlled or related persons) from controlling a small business

¹⁴ The recently enacted stimulus legislation increased this from 20% plus an additional amount for SBICs using more than \$90 million of Leverage.

except on a temporary basis to protect its investment or if the small business was a “start-up”. In December 2000, legislation was enacted eliminating the legislative basis for regulating “control during the investment period”. Effective November 21, 2002, SBA adopted final regulations indicating that an SBIC and its Associates may control a small business for up to 7 years, and with SBA’s consent, for a longer period, to permit an orderly sale of the investment or to ensure the financial stability of the small business.

SBICs are precluded from making investments in a Small Business if it would give rise to a conflict of interest. Generally, a conflict of interest may arise if an Associate of the SBIC has or makes an investment in the Small Business or serves as one of its officers or directors or would otherwise benefit from the financing. Joint investing with an Associate (such as another fund controlled by affiliates of the General Partner) may be made on identical terms or on terms that are fair to the SBIC.

Financing Terms

An SBIC may make investments in the form of Loans, debt with equity features (“Debt Securities”), or Equity Securities. Debt Securities must be issued for a term of not less than one year (except for bridge loans in anticipation of a permanent financing in which the SBIC intends to participate, or to protect its prior investment) and must have amortization not exceeding “straight line”. The permissible interest rate on Debt Securities depends on whether they are “straight debt” or debt with equity features. For straight Loans, the permitted rate is the higher of (i) 19%, or (ii) 11% over the higher of the SBIC’s weighted cost of Debenture Leverage or the current Debenture Rate. For Debt Securities, the permitted rate is the higher of (i) 14%, or (ii) 6% over the higher of the SBIC’s weighted cost of Debenture Leverage or the current Debenture Rate. Regulations define an SBIC’s weighted cost of Debenture Leverage and describe the permitted rate when more than one SBIC participates in the financing.

In addition, SBICs may structure financing to receive a royalty based on improvement in the performance of a portfolio company after the financing.

The applicable interest rate is calculated using all points, fees, discounts and other costs of money other than application and closing fees of up to 5% of the financing (if it is a Debt Security, (i.e. debt with equity features) or 3% for Loans (without equity features), that may be charged in addition to the permitted interest. In addition, an SBIC may be reimbursed for its routine closing costs (including legal fees).

An SBIC using Participating Securities must invest an amount equal to the original issue price of its Participating Securities in Equity Capital Investments (common or most forms of preferred stock; or Debentures that are not amortized prior to maturity, are unsecured, and have interest contingent upon earnings).

An SBIC may require a Small Business to redeem the SBIC’s equity investment, but only after one year, and only for a price based on a pre-determined formula based on the book value and/or earnings or a third-party appraisal by a mutually agreed upon, qualified

appraiser. Mandatory redemptions not complying with these requirements will be treated as if they were Debt Securities. However, the Small Business may be required to redeem the SBIC's equity security if the Small Business has a public offering, has a change of control or management or defaults under its investment agreement.

An SBIC may retain its investment in a business that ceases to be small, and may continue to invest in such a "large" business until it has a public offering. Following a public offering by such a "large" business, the SBIC still may exercise rights to acquire securities that were obtained while the business was small.

SBIC Operations

SBA has adopted a number of regulations and policies concerning operating requirements of SBICs intended to assure their proper management. Principal regulations and policies include:

An SBIC using Leverage must invest its "idle funds" not invested in Small Businesses, in liquid, safe, short-term investments specified in the regulations (principally, U.S. government obligations, repurchase obligations, federally-insured deposits, and deposits in "well-capitalized" federally-insured financial institutions).

An SBIC and its Associates may provide management services to Small Businesses in which the SBIC invests, but only may charge for services at competitive rates for services actually rendered. SBA requires that SBICs applying for a license after April 1, 2004, must credit all such fees against the management fee otherwise payable by the SBIC to the management team (except for placement fees paid to associated licensed broker-dealers).

The General Partner or Board of Directors is required to value the SBIC's assets annually (semi-annually, if Leverage is used) pursuant to valuation guidelines approved by SBA. SBA has issued model valuation guidelines that are similar to those customarily used by venture capital firms.

If an SBIC issues Leverage, it will be required to avoid "Capital Impairment" which will be considered to exist if the SBIC's "Capital Impairment Ratio" (calculated by adding the SBIC's realized losses and net unrealized depreciation¹⁵ and dividing the result by the SBIC's private capital) exceeds permitted levels detailed in the regulations and which vary depending on the proportion of equity investments made by the SBIC.

An SBIC's ability to borrow funds from third parties is subject to SBA regulation. SBICs only may incur unsecured debt.

¹⁵ The actual calculation is complex as certain types of unrealized appreciation are not fully credited.

SBICs are required to file a variety of reports with SBA, none of which generally are considered burdensome. These reports include an annual financial statement which is certified to by the SBIC's independent certified public accountants (and contains information concerning each portfolio company), valuation reports as described above, reports as to changes in the SBIC's management, material litigation, a brief report describing each investment, and copies of reports sent to investors and, if applicable, to the SEC. SBA will conduct regulatory examinations of each SBIC on an annual basis.

Current SBA regulations provide SBA with certain rights and remedies if the Fund violates their terms. A key regulatory metric for SBA is the extent of "Capital Impairment", which is the extent of realized (and, in certain circumstances, net unrealized) losses compared with the SBIC's private capital commitments. Interest payments, management fees, organization and other expenses are included in determining "realized losses". SBA regulations preclude the full amount of "unrealized appreciation" from portfolio companies from being considered when calculating Capital Impairment in certain circumstances. Remedies for regulatory violations are graduated in severity depending on the seriousness of Capital Impairment or other regulatory violation. For minor regulatory infractions, warnings are given. For serious infractions the use of Debentures may be limited or prohibited, outstanding Debentures can be declared to be immediately due and payable, restrictions on distributions and making new investments may be imposed, management fees may be required to be reduced, and investors may be required to pay their unfunded capital commitments to the SBIC. In severe cases, SBA may require the Limited Partners to remove the Partnership's General Partner or its officers, directors, managers or partners, or SBA may obtain appointment of a receiver for the Partnership.

Organization

SBICs are organized under state law as corporations, limited partnerships or limited liability companies. SBICs using Participating Securities only could be organized as limited partnerships. SBA strongly encourages Debenture SBICs to be organized as limited partnerships.

Investors

Investors may be either domestic or foreign individuals or entities. The SBIC Act specifically authorizes banks and Federal savings associations to invest up to 5% of their capital and surplus in SBICs¹⁶. Certain investors owning 33% or more of an SBIC are required to submit certain background information to SBA and are subject to SBA's fingerprinting requirements. All investors in an SBIC and anyone owning 10% or more of any investor owning 10% of an SBIC must be identified to SBA in the SBIC's application for licensure.

¹⁶ The recent proposal by the Administration to restrict certain bank investment activities explicitly permits bank investments in SBICs.

Diversity of Ownership

SBA has regulations and policies designed to assure that an SBIC receives significant investments from investors who do not participate in or otherwise control its management. Additionally, an SBIC must receive at least 30% of its private capital from a total of three or more investors who are unrelated to the management or from a single such investor meeting certain limited qualifications (such as a bank, insurance company or certain publicly traded corporations). No single investor may own more than 70% of an SBIC's private capital.

Restrictions on Transfer

Investors in an SBIC may not transfer their interests without SBA's prior consent. Additionally, as a condition to providing Leverage to the SBIC, SBA presently requires investors owning 50% or more of an SBIC that uses Leverage (as well as the SBIC's managers and other "control persons") to enter into a written agreement with SBA providing for personal liability for repayment of Leverage for directly or indirectly participating in a change of control of an SBIC without SBA's prior consent. Additionally, without SBA's consent, an SBIC may not release any of its investors from the liability to make the full amount of their capital contribution.

Management Fee

Management fees paid by SBICs using Leverage are subject to SBA's prior approval. Leveraged SBICs that submit license applications from and after April 1, 2004, are permitted to charge a management fee of 2.5% on three times the amount of "Regulatory Capital" (without subtracting distributions made) for five years, and thereafter 2.5% of the cost basis of loans and investments in active portfolio companies. However, if the base on which the fee is calculated exceeds \$60 million, the permissible rate declines to 2% when the base is \$120 million or more. SBA policies require that management fees be reduced by all consulting, board and other fees received from portfolio companies by affiliates of the SBIC's general partner (except for fees paid to licensed broker-dealers). SBICs that filed their license applications before April 1, 2004, are not required to offset fees from portfolio companies and are permitted to charge an annual management fee of 2.5% of three times the amount of Regulatory Capital (without reduction for distributions) for five years and thereafter 2.5% of the amount of outstanding Regulatory Capital and Debentures that are issued and outstanding plus an additional \$125,000 may be paid each year when the base on which management fees was calculated is less than \$20 million. SBA only permits increases in Regulatory Capital to create a prospective entitlement to increased management fees (i.e., the increased level of management fees only may be charged from the beginning of the calendar quarter in which the Regulatory Capital is increased, not the date of the initial closing). SBA's policies concerning Management Fees are quite detailed and are set forth in Tech Note 7 and Tech Note 7A (pertaining to SBICs filing license applications beginning with April 1, 2004).

Licensing

SBA uses a two-step licensing process for “first time” SBICs. In the first phase, an applicant completes an SBA form entitled Management Assessment Questionnaire (“MAQ”). This contains the elements of the applicant’s business plan as well as detailed information concerning the experience of each of the “Principals” to carry out the business plan. SBA generally requires that at least two, substantially full-time, members of the team have at least five years of successful private equity investment experience at a decision-making level. The MAQ is then reviewed by SBA’s “Investment Committee”, after which the Principals, if appearing qualified, are invited to meet with the members of the Investment Committee. After the meeting with the applicant’s Principals, SBA’s Investment Committee may turn the application down or issue a “green light” letter to applicant indicating that it has passed the first part of the application process and now is authorized to file a formal application. At the present time, a “green light” letter usually is issued three to four months following submission of the MAQ.

After receipt of the “green light” letter and obtaining commitments for at least the minimum required Regulatory Capital (\$5 million for SBICs using Debentures)¹⁷ from investors satisfying the “diversity” requirement, the applicant files a formal application which contains additional information about the applicant and the management team, as well as its formal legal documents. During the formal licensing process, SBA seeks to determine that there is a qualified management team and that the SBIC has a good chance of operating profitably. SBA reviews the applicant’s business plan, projections and legal documents, and conducts reference and other background checks on the management team. The process presently is taking approximately six to ten months (which SBA is seeking to shorten). SBA requires applicants to advise their investors that the investors are not entitled to rely on SBA’s review of the applicant in deciding whether to invest.

Investments made by a prospective SBIC prior to filing its formal license application with SBA will not be included in its SBA “Regulatory Capital” once it is licensed. However, after an application is filed, an applicant may make “pre-licensing investments” which will be included in the applicant’s Regulatory Capital if they are submitted to SBA for approval prior to the investment being made. SBA requires 10 business days to review such pre-licensing investments (but approvals frequently take longer). SBA does not seek to “underwrite” the investment, simply to determine if the investment is made in compliance with SBA Regulations. Once licensed, such pre-approval of investments is not required. SBA requires all principal members of the management team to attend a one-day regulations class run by SBA and will only permit one “pre-licensing” investment to be made prior to at least one person from applicant attending the class. Arrangements for attending the regulations class are made by contacting NASBIC.

¹⁷ During the last year, SBA has adopted a policy requiring Applicants to have firm and binding commitments for sufficient Regulatory Capital to hold a first closing and conduct successful operations even if no additional capital subsequently is raised.

Timeline

Applicants should assume the following timeline for securing a license and Leverage.

Management Assessment Questionnaire	3-4 months
Formal License Approval	6-10 months
Receipt of Leverage Following Licensing	<u>1-2 months</u>
	10-16 months

Use of More than One-Half of One Tier of Leverage Following Licensing	6-10 months after licensing
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This assumes the license application is filed immediately upon receipt of the “green light” letter.

Licensing Second Funds

For “second” SBIC funds, SBA follows a process that is similar to licensing new funds. The first step consists of SBA’s Office of Operations analyzing the prior fund (similarity of business plan, changes in management team, track record, profitability, liquidity and prior SBA compliance record) and making a recommendation to the Investment Committee that ultimately leads to issuance of a “green light” letter. Following its receipt, when the new fund has received commitments for the minimum required capital that satisfies the “diversity” requirement, the fund may submit a formal application for processing. If the “second” fund continues the investment strategy of a successful SBIC and the management team is basically the same, SBA has adopted a new “fast track” licensing process designed to shorten the process to less than six months.

PEPPER HAMILTON LLP

SMALL BUSINESS INVESTMENT COMPANY PRACTICE

Pepper Hamilton LLP, with 11 offices and more than 500 lawyers, provides corporate, litigation and regulatory services to national and international companies, emerging businesses and individuals. The firm has the country's largest and most active Small Business Investment Company practice.

Pepper Hamilton serves the SBIC industry in the following ways:

- Fund formation
- Assistance in licensing
- Regulatory advice to licensed Small Business Investment Companies
- Fund investment activities
- Serving as counsel to portfolio companies
- Provision of advice concerning systematic improvements to the SBIC Program

Founded in 1890 in Philadelphia, Pepper Hamilton today has offices in Philadelphia, Pennsylvania Washington, D.C. and Detroit, Michigan, Wilmington, Delaware; New York, New York; Boston, Massachusetts; Berwyn, Pittsburgh and Harrisburg, Pennsylvania; Orange County, California; and Princeton, New Jersey.

Why Select Pepper Hamilton

It makes sense for you to select Pepper Hamilton as your SBIC counsel for the following reasons:

Experience. Pepper Hamilton has enormous SBIC experience. **Mike Staebler** ran an SBIC for six years and has served as counsel to more than 180 licensed SBICs since 1972. He assisted NASBIC in negotiating the SBA regulations implementing the "new" SBIC program from 1992-94 and has provided advice to SBA in connection with the creation of many of its forms and policies. Since 1994, he has helped more than 160 SBICs become licensed by SBA. **Julie Corelli** has more than 20 years of fund formation and deal-related experience and has worked extensively with SBICs during the past five years. **Doug Camitta** has counseled dozens of SBICs for more than 24 years concerning regulatory matters, their formation and their investment activities and has provided counsel to SBA concerning a number of their forms and policies. **Vicki Harding** has more than 20 years of experience working with venture capital firms and technology-based companies. **Mike Temple** (nine years) has intensive experience in

connection with the formation, licensing, regulatory and investment activities of SBICs. **Todd Betke, Chris Rossi** and **Lisa Jacobs** have extensive experience in fund formation and the investment activities of private equity, mezzanine and venture capital firms.

Depth of Experience. Establishing an SBIC requires extensive knowledge of partnership and corporate law, securities law, taxation (foreign and domestic) and ERISA laws, as well as in-depth knowledge of the SBIC Regulations. **Lisa Petkun** and **Laura Warren** have provided SBIC tax advice for 25 years. **Joe Del Raso** formerly was the SEC attorney handling publicly traded business development companies. **Brad Boericke** has extensive experience in advising financial institutions in SBIC investment. The firm has researched extensively the availability of **Community Reinvestment Act** credit for investments by financial institutions in SBICs as well as the interaction of state-sponsored economic development programs with SBIC requirements.

Working with Your Regular Counsel. The firm is equally happy to handle all aspects of your SBIC's formation and licensing, or to work in conjunction with your regular counsel. Pepper Hamilton has established excellent working relationships with many of the country's other leading law firms and regularly receives referrals from them.

Cost Effective. Having seen "almost all of it" before, the firm is equipped to provide informed, experienced advice to assist you in "getting it right" the first time.

Fund Formation

Pepper Hamilton assists prospective SBICs in structuring their funds and raising private capital. The firm has a national perspective and extensive experience in negotiating relationships between principal fund managers and between fund sponsors and limited partners.

The firm regularly advises clients concerning all aspects of fund formation and management, including domestic and foreign tax structuring, ERISA and compliance with federal and state securities laws.

Licensing

Pepper Hamilton has represented more than 170 firms in obtaining licenses as SBICs or SSBICs. Of these, over 160 have received their licenses since August 1, 1994. In addition, the firm represents numerous management teams in the process of fundraising or obtaining a license. These firms are located throughout the United States, are structured as limited partnerships, corporations and limited liability companies, and have investors that include large public and private pension funds, state and local governmental agencies, banks and bank holding companies, tax-exempt entities, individuals and foreign individuals and entities.

Regulatory Advice

The firm provides ongoing regulatory advice to licensed SBICs covering the full range of SBA regulatory compliance.

Fund Investment Activities

Pepper Hamilton regularly handles investments for SBICs, venture capital and private equity firms located throughout the United States. Our clients have invested at all stages of development of portfolio companies, including seed and early stage, growth, mezzanine and buyouts. Clients have invested across all industry sectors, including e-commerce, biotechnology, health, telecommunications, information technology, manufacturing, distribution, outsourcing, publishing and retail. Portfolio companies are both privately held and publicly traded. Several of our clients sponsor or have relationships with incubators/accelerators. Pepper Hamilton has an extensive merger and acquisition practice and is accustomed to regularly representing buyout as well as venture capital investors.

Counsel to Portfolio Companies

We are experienced in all aspects of representing portfolio companies. We have helped companies grow from their initial incorporation and negotiation of their initial small contracts into large multi-national businesses. We advise growing businesses with respect to strategic alliances, technology licenses, incentive compensation plans, protection of intellectual property, personnel matters, securities compliance, relationships with suppliers and customers, banking and other financial relationships, and creditor rights matters. We have a large securities practice that handles public offerings on behalf of issuers and underwriters.

Support of the SBIC Industry

Pepper Hamilton has been a member of the National Association of Small Business Investment Companies (NASBIC) since 1981, and has provided extensive support and counsel to the industry. Our lawyers have worked closely with NASBIC and the U.S. Small Business Administration to assist in developing regulations and SBA policies implementing the “new” SBIC program in 1992. The firm has helped develop several of the forms used by SBA. The firm continues to provide advice and counsel to industry leaders as changes to the SBIC Program are discussed.

Pepper Hamilton has sponsored and helped organize numerous seminars on the formation and operation of SBICs. Members of the firm are frequent speakers concerning the SBIC program at industry meetings and the NASBIC Venture Capital Institute, as well as at gatherings of prospective investors, accountants, lawyers, development officials, venture

capitalists and businesspeople. Our lawyers regularly meet with NASBIC and SBA officials concerning industry policies and practices.

Practice Group Members

Pepper Hamilton’s SBIC Practice Group is led by Michael B. Staebler (Detroit and Washington, D.C.). Mike served for six years as president and CEO of an SBIC located in Ann Arbor, Michigan (prior to its sale to NBD Bancorp (now JP Morgan Chase) and has represented numerous SBICs and venture capital firms since 1972. He has authored several articles describing the formation and operation of SBICs, has served on SBA’s Advisory Counsel and has chaired the SBIC subcommittee of the American Bar Association.

Other members of Pepper Hamilton’s SBIC Practice Group include H. Douglas Camitta, Vicki R. Harding, Michael A. Temple, Candace L. Gaston, Janet L. Beyer (SBIC Project Administrator) and Karen Petty (Administrative Assistant) (Detroit); Todd W. Betke, Christopher A. Rossi (Berwyn); Julia D. Corelli, Lisa R. Jacobs, J. Bradley Boericke, Joseph V. Del Raso, Lisa B. Petkun, and Laura D. Warren (Philadelphia); and Todd W. Betke (Washington DC).

Pepper Hamilton Offices (Partial Listing)

DETROIT Suite 3600 100 Renaissance Center Detroit, MI 48243-1157		PHILADELPHIA 3000 Two Logan Square Eighteenth and Arch Streets Philadelphia, PA 19103-2799		WASHINGTON, D.C. 600 Fourteenth St. NW Washington DC 20005	
Michael B. Staebler	313.393.7394	J. Bradley Boericke	215.981.4790	Michael B. Staebler	202.220.1432
H. Douglas Camitta	313.393.7454	Julia D. Corelli	215.981.4325	Todd W. Betke	202.220.1221
Vicki R. Harding	313.393.7324	Joseph V. Del Raso	215.981.4506		
		Lisa R. Jacobs	215.981.4701		
Michael A. Temple	313.393.7385	Lisa B. Petkun	215.981.4385	BERWYN	
Candace L. Gaston	313.393.7487	Laura D. Warren	215.981.4593	899 Cassatt Road	
				Berwyn, PA 19312-1183	
Janet L. Beyer, SBIC Project Administrator	313.393.7329			Christopher A. Rossi	610.640.7846
B. Karen Petty, Administrative Assistant	313.393.7410				

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