U.S. SECURITIES AND EXCHANGE COMMISSION

SMALL BUSINESS CAPITAL FORMATION ADVISORY COMMITTEE MEETING

Tuesday, July 30, 2024

10:00 a.m.

Amended: 8/15/2024

U.S. Securities and Exchange Commission

100 F Street, N.E., Washington, D.C.

APPEARANCES:

Gary Gensler, SEC Commissioner, Chairman
Mark Uyeda, SEC Commissioner

Committee Members
Wemimo Abbey
Stacey Bowers
George Cook
Vincent Cordero
Marcia Dawood
Greg Dean
Bailey DeVries
Herbert Drayton III
Bart Dillashaw
Erica Duignan
Laura Niklason
Jasmin Sethi
Aren Sharifi
Marc Oorloff Sharma
Dennis R. Sugino

Presenters
Steve Glover
Kate Price

APPEARANCES (Cont.):

SEC Staff
Courtney Haseley
TJ Collins

P R O C E E D I N G S

MS. DUIGNAN MINNIHAN: Good morning and welcome to today's meeting of the SEC's Small Business Capital Formation Advisory Committee. I call this meeting to order. I want to extend a warm welcome to everyone. It's great to see all of you. We also appreciate members of the public who have tuned in to watch the meeting via webcast on SEC.gov.

We've been talking extensively over the course of our last several meetings about ways to expand access to early stage capital raising, including through proposed modifications to regulation crowdfunding.

We are pleased to report that our recommendation on improvements to the definition of accredited investor was finalized and delivered to the Commission earlier this month. All of these recommendations were made with a view towards positively affecting capital raising for both entrepreneurs, small business and investors.

Today we'll focus on exploring recent changes to the Small Business Administration's Small Business Investment Company or commonly known as SBIC Program, designed to increase inclusivity and access to funding for small businesses, startup and fund managers. This is an area some of us may be unfamiliar with, while some of my fellow committee members know about the SBA's historical SBIC programs. The SBA has recently unveiled modernizations to reinvigorate the program, opening up potentially billions of dollars to venture capital funds. It is these modernizations that we'll be discussing today.

I'm really looking forward to learning more about these changes and to the committee's discussion on this topic. One of our goals will be to understand more about how these changes are intended to work, the impetus for the changes, and what kind of investors might benefit from participation in the SBIC program, but most importantly how small companies in America can be positively impacted.

But before we begin our discussions, we are so pleased to welcome remarks from Chair Gensler and Commissioner Uyeda. We really appreciate you being with us this morning. I know that a few of the Commissioners are unable to join us this morning due to scheduling conflicts.

Chair Gensler, we would love to invite you to start with your remarks.

CHAIR GENSLER: Thank you so much. I'm

pleased to speak before the committee. As is customary, I would like to note that my views are my own as Chair. And I'm not speaking on behalf of my fellow Commissioners or staff. Of course you'll hear directly from Commissioner Uyeda.

I understand the Committee will discuss the recent changes in the Small Business Investment Company program under the SBA. You'll hear from industry stakeholders, as well as, Bailey DeVries who leads the SBIC program as Associated Administrator over at the SBA. So thank you, Bailey, for joining us.

When Congress established this program, the so-called Small Business Investment Company Program, it was 1958, and the intent, and this was in Congress's words was, quote, to stimulate and supplement the flow of private equity capital. Think about that, stimulate and supplement the flow of private equity capital, long-term loan finds, which small business concerns need and which are not available in adequate supply, end quote. That was 1958.

Through the program, the small business administration provides government guaranteed loans to types of private sector investment funds called

SBICs. And these SBICs in turn invest in small businesses. So there are funds there. The Small Business Administration puts out annual reports and based on the most recent annual from late last year there's about 320 of these funds. And they manage about $43 trillion in capital. $43 billion, I'm sorry, $43 billion in capital.

Now this includes some commitments. So it's only about 28 billion of actual outstanding leverage and 15 billion of commitments. The small business investment companies are typically structured to be exempt from registering with the SEC under the Investment Company Act. This was Congress organized it. And they typically raised money in reliance to regulation D, as well.

As I mentioned, Congress, Congress actually passed something in 2015, the FAST Act, and based upon that we actually did a follow-up role that allows the advisors to also not register under the Investment Advisors Act. So our role here is really learning from this market, seeing what we can do, but the SBICs and the advisors don't register, but they are still subject to important protections under the law, the anti-fraud protections.

Now I understand the SBA recently reformed this program, diversified, expanded the network of licensed private funds to so-called accrual SBICs that allow accrual and delay of some of the payments of interest, re-investor SBICs. And I look forward to hearing from the Committee about the program as well as the opening discussion that you're also going to have, I understand, on the broader economic environment.

When you're talking about the broader economic environment, in particular I would be interested about how the current invest rate environment has affected access to capital for small business. We've gone through these past two years. Rates of course have moved up. You can look at the interest rate curve and just how that's affected small business as you're discussing it.

With that, I thank you, and hand it back over to you and Commissioner Uyeda.

MS. DUIGNAN MINNIHAN: Thank you so much, Chair Gensler, we really appreciate your remarks. And Commissioner Uyeda, thank you for being here and we would love to hear your thoughts.

>>COMMISSIONER UYEDA: Thank you very much, Erica. Good morning to all. I appreciate the Chair's reference to the FAST Act, which stands for

Fixing America's Surface Transportation.

And so you never know when one of the laws that affect the capital markets will be attached to a transportation infrastructure bill or more recently to the National Defense Authorization Act. So often times we find ourselves here at the SEC referring to laws which ordinarily one would not necessarily think would affect the capital markets, but indeed they do.

It's a pleasure to be you at today's meeting. At the last meeting the Committee discussed how regulation crowdfunding could be improved to expand its use for early stage capital raising. Thank you very much for your thoughtful recommendation that Regs CF's threshold, which reviewed financial statements are required, be raised from $124,000 to $350,000.

This increase would mean that companies offering less than 350,000 within a 12-month period would be able to use certified financial statements and tax return information in lieu of financial statements reviewed by an accountant. While financial statements can be informative to investors, independent review by an outside accountant can be costly relative to both the modest amount of capital being raised and the benefits to investors from such review.

The antifraud provisions of both Federal and State Securities Laws are already a strong deterrent against the presentation of false and misleading financial statements and other offering materials. By avoiding the cost of an outside accountants, companies might be more likely to use Regulation CF. I encourage the Commission to consider this recommendation to improve capital formation.

Before the committee discussing SBICs I understand that committee members will be providing some observations on the current state of small business capital raising. While discussing this topic and making recommendations, including recommendations that may come further along later this year or next year, I encourage you to consider three things.

First, don't be limited by existing laws and regulations. While some ideas can be implemented by Commission rule making, others by require Congressional legislation. That's okay. The audience for your discussion and recommendations is not the only the Commission. Members of Congress, their staff, practitioners, academics, and the public will see your recommendation. So don't hold back.

Second, be as specific as possible in identifying the problem needing to be solved. While capital formation and investor protection are part of the Commission's mission, they can be abstract concepts. Consider pinpointing the specific factors that are preventing small businesses and entrepreneurs from obtaining the capital they need. If investors are not being adequately protected, how additional disclosure or rule changers offer that protection.

Finally, to the extent possible, write data, or ask for data to support the problem you've identified or the solution you've proposed. Anecdotes and examples are helpful, but regulatory policy should not be driven by a handful of stories and incidents. In contrast, decisions served by data reflect a more thoughtful approach to regulation. Stacey Bowers and her team have a wealth of data available. So please use the resources available to you.

According to this afternoon's topic on the agenda are the recent changes to the SBIC Program. This program provides another avenue for small businesses to access early stage capital. I'm really glad that we have one of the Committee members Bailey

DeVries, who leads the program in a role at the Small Business Administration.

So I look forward to reviewing a readout of the discussion you have today. Thank you very much. And I look forward to you all having a very productive meeting.

MS. DUIGNAN MINNIHAN: Thank you so much. Thank you, Chair Gensler and Commissioner Uyeda. Your remarks are always a wonderful way to start our discussions.

I would love to take this moment to thank Sue Washer who has served as vice-chair of this Committee for her service and invaluable contribution to our efforts. Sue hoped to be with us here today but is unable to attend due to an unavoidable conflict. We're extremely grateful for the work during her tenure and she will be missed as her term expires after this session. Thank you.

So next, we want to take some time to tap into the expertise and experience around this virtual table. And we'll hear from each of our members about what you're observing in your industries, fields and markets with respect to small business capital raising.

This is something that we did at our

meeting in February. And I think it's again timely for us all to share observations from our unique vantage points about issues and hot topics that we're seeing affecting small businesses. This not only helps us share insights from across the country with the SEC, but it also identify trends and potential challenges that this Committee may consider exploring at future meetings.

So I would like to go around the room and invite each Committee member to take a couple minutes to share your perspectives on the state of the capital raising market for small businesses in the U.S. To give you a warning, I'll be calling on members in alphabetical order by last name and would like to start with Wemimo. Okay. For now we will move onto Donnel. No Donnel. Okay. Great. We will then move onto Stacey.

MS. BOWERS: Great. Thanks, Erica. I am definitely here. So I just want to say, our office really appreciates hearing all of the Committee members' insight about what each of you are seeing in your diverse areas with regard to small businesses capital formation. And Erica, hopefully you'll be able to circle back to Wemimo and Donnel.

So as many of you know, the Commission held a small business forum in April. And it brought in participants from all over the U.S. As a result of that forum our office got really great feedback from the event, and feedback also being echoed by others as we engage in our own outreach across the country. So I just want to share a few of the highlights from the forum to maybe set the stage. All of you are experts in your own ways. So I want to hear more of what you have to say.

So just some highlights we heard during the forum include that more small businesses expect to find capital within their local community than from across the country or internationally. We also learned that many of the participants indicated the primary way they raised capital was from grants, loans or other non-dilutive sources with angel and accredited investors being the next most highly used source for capital. And we learned that top priorities for smaller public companies are attracted more institutional investors and simply engaging with their investors.

And then lastly, we heard it at the forum and we hear it time and again about the importance of networks and professional mentorship for small business success. So what I know is the thoughts and perspectives that you are going to share in this meeting today are useful to our office as we continue to engage in our own outreach and expand our educational resources.

We always welcome feedback on that front or ideas about other resources we should consider adding to our own hub. I want to highlight the SEC's website recently went through a change. So if you're looking for our resources you can find them now from the SEC's home page by clicking on the small businesses link in the upper right corner. We're hope toking launch several new resources in the coming months, including a few that are designed for later stage and potential reporting companies.

Finally, I'm going to tack onto what Erica said previously. And I just want to thank our outgoing Committee member Sue Washer, for her leadership and service on this committee and sharing her valuable insights over the past four years. Thank, erica.

MS. DUIGNAN MINNIHAN: Thank you so much Stacey. We appreciate your remarks. Wonderful. Up next I would like to invite George cook. I'm George.

MR. COOK: Hi. Good morning, everyone. Good to be here. I'm George Cook, I'm the cofounder and CEO of Honeycomb Credits. Deeply focused on capital formation for very early stage small businesses, particularly the 95 percent plus percent of businesses who are not eligible for venture backing or equity funding, but really rely on fair and affordable debt offerings to be able to grow and thrive. There's some really promising data coming out of the SBA loan program 7(a) loans have been surging in recent years reversing a long-term trend of a downward trajectory which is really promising.

If you start to go into those data a little deeper, you realize at the same time that the number of SBA loans is growing very rapidly. So too is the average size of an SBA loan. It's actually about three times higher than it was before the Great Recession. That means that for a lot of traditional lenders exercising and using the SBA Loan Program, the definition of a small businesses has changed. That's not a bad thing, it just means we're moving upstream and serving a little bit more well-established small businesses getting into midsized small businesses, but we're missing a rung on our ladder. The first rung of businesses who have outgrown small grant programs, have outgrown personal savings or their own personal credit card, but can't quite get to that SBA loan yet.

So I'm really excited to talk about SBICs here today and learn how they might be a piece of that puzzle, but I remain committed and excited about the power of regulation crowdfunding as a piece of this puzzle. I believe that it's a really powerful tool to decentralize capital formation and allow retail investors who know communities and entrepreneurs better than anyone else, the ones that they're investing in in their own local community, are able to access data and intelligence that someone in New York or San Francisco might not have.

But there are limitations to regulation crowdfunding. We talked a lot about that at our last meeting. I'm really proud of the recommendations that this Committee put forward at the last meeting. Thank you Commissioner Uyeda for summarizing them. But increasing the requirement for review financials from $124,000 to 350 would dramatically lower the cost of capital for a lot of entrepreneurs while simultaneously bringing more businesses onto regulation crowdfunding platforms, allowing more businesses to access capital at fairer rates and supporting a lot of local economic development. Thank you.

MS. DUIGNAN MINNIHAN: Thank you, George. One quick follow-up to Chair Gensler's question since you do operate with some fixed income product. Would love to know your thoughts on the impact of increased interest rates on your area of the market.

MR. COOK: Yeah. It's -- I think the definition of the Fed raising rates is to lower demand for capital and they've done that. There are a lot of business owners that we talk to who are cautious about taking on debt at these higher rates. They are eagerly awaiting rates to start coming down. And they're putting off capital expansion projects.

So I think there was certainly an initial sticker shock when rates were rising faster than I think they ever have in U.S. history. I think the market has become a little bit more comfortable with the higher-rate environment. But every single day myself and my team are talking to entrepreneurs who are putting off expansion projects because of the high-rate environment.

MS. DUIGNAN MINNIHAN: All right. Thank you so much. We really appreciate the thoughtful insight, George. Wonderful.

Next up, I would love to invite Marcia to share remarks.

MS. DAWOOD: Good morning, everyone. I'm Marcia Dawood, former Chair of the Angel Capital Association and still current board member.

Couple things I would like to note, that it does remain still an investor-friendly climate because entrepreneurs are not seeing the leverage that they had in 2020 and 2021. If they did not have cash on hand and they haven't seen revenues materialize, they're feeling a lot of pressure because they have shorter runways and we're seeing more companies that are having to raise on a down round.

PitchBook estimates that the demand for startup capital greatly exceeds the current supply. That for every one dollar of supply there's 1.6 in demand. And that some vertical markets, like life science technologies, there's an imbalance that's even greater.

What we're really seeing is a big boom in the AI market. So more than 40 percent of all funded startups were in artificial intelligence. So that makes it even more critical for those traditional startups that are non AI. If we remove all of the AI bubble that we're currently in.

Startup funding will not increase

significantly until the IPO window opens and there's more positive mergers and acquisitions. We just haven't been seeing exits. So some expect that those markets will improve in the second half of the year. There was actually just a report last week on the M&A market starting to pick up for private equity. So that will hopefully trickle down to us at the angel level. We haven't seen a lot of activity, that means angels don't have a lot of capital to deploy. That makes it harder and harder for startups.

Last thing I'll mention is that fund managers, especially first time and emerging fund managers, especially those with a diversity focus, they're finding it increasingly challenging to sell LPs and a lot of that is about the pressure for early stage capital for founders, what I was just mentioning, due to the lack of liquidity in the market. Thank you.

MS. DUIGNAN MINNIHAN: Thanks, Marcia. Appreciate that.

Greg, would love to invite you for remarks.

MR. DEAN: Good morning. Thank you so much. I just want to highlight to everybody that the sixth annual FINRA Industry Snapshot was just released a couple weeks ago and I can post the link to that.

Two really good observations this year is one, the number of crowdfunding portals has gone up. So we have increased last year, which has steadily increased over the past couple years.

In addition we're seeing a number of small broker dealer firms are focusing on capital markets' businesses. Which should be good news, because this means the focus on capital markets could mean smaller deals as well as working with smaller businesses trying to access and do IPOs in the market.

MS. DUIGNAN MINNIHAN: Thank you, Greg. Much appreciated. Next up, Bart.

MR. DILLASHAW: Thanks, Erica. It's great to see everyone. I'm Bart Dillashaw. I am an attorney with Enterprise Legal Studio. Sort of caveat, my view on this is focused on the early stage angel VC sort of the capital raising area. I echo a lot of Marcia's observations as well. I think it's been a big pullback from 2021, 2022, and we saw a big decrease in the availability of capital raising opportunities from VCs. I will say I think it has stabilized a little bit. I don't feel like it is continuing to decrease, but it is harder for companies to raise capital.

I think for all of the reasons that Marcia said, lack of IPO window, lack of M&A activity. I think some of that has been affected by interest rates. Obviously the hurdle for getting a return for some of the capital has increased relative to the rates. I think we're seeing that play out in the market.

One of the things I'm very interested in the topic today with regard to the SBIC interest is the opportunity to report new fund formation. I live in the middle of the country in Nebraska, where things we struggle with is early stage funds. Especially funds that are focused on the sort of series A area. And part of that is just not the LP base here. There's not the experience with investing in those types of funds, with managing those types offer funds. So anything that sort of support or foster that I'm very interested to hear more about.

MS. DUIGNAN MINNIHAN: Thanks, Bart. Appreciate that.

Would love to call on Wemimo.

MR. ABBEY: Thanks a lot for the opportunity to address the forum. I think what we are seeing from the startup environment, specifically the lane I operate in, Series B startup and on the path to IPO. We've really seen a crunch in the fin tech environments, particularly without AI, a downward pressure on funds going to startups. A lot of folks within the startup environments, who I know and from data, shows that we don't have a lot of capital influence. It's still a very investor-friendly market.

Valuations on an average 30 to 40 percent down and a lot of pairs I know are running out of business. So it's very alarming but the folks getting the better end of the market is folks that essentially have access to some sort of AI empowered solution or claims to have the solutions and there's a lot of enthusiasm about what the technology could do. The application is still going to take a little bit of time. Although the enthusiasm is also much. We saw on record with large companies like Open AI and what methods just deployed recently.

So the mood is very, very tempered. Lack of capital is essentially the order of the day. And growth startups, particularly in the Series A and Series B arena are really struggling to raise capital or when they do raise capital it's incredibly dilutive or in some cases pushes them out of the business. So that's what we've seen.

What we've been able to do to weather the storm which is crucial when having this conversation is a very focused approach. Which is the drum roll, do not run out of money, control expenses. That's been what fellow sort of Unicorn Founders, which means companies that are valued above a billion dollars and just companies that are around $500 million control what you can control. Do not overspend. The IP's rates will be longer with some optimism though you might get some cuts before the end of the year.

So that's sort of what we are seeing in the marketplace. Access to capital is really slow with the exception of companies that have applied by AI or have some sort of AI incorporation to them. And a lot of companies are really struggling at this moment.

MS. DUIGNAN MINNIHAN: Thank you so much. That's really valuable insight. Next I'd like to invite Herbert.

MR. DRAYTON III: Good morning, Erica. Thank you so much. What's happening at the ground level here is there continues to be governance and financial acumen issues that's compromising small businesses’ ability to attract capital. The capital is available. It's just that folks can't -- folks are still struggling with defining their businesses based on the financials of the business. Also, not wanting to move away from having vanity boards instead of governance boards. Those two things continue to be a problem.

We're also seeing that affinity groups, partnering with some affinity groups, to give them access to larger networks where they could have access to capital or just expand their network so they could get customers. These are companies that from the report last year, folks that could use $50,000 to really get some velocity in their companies, but they just don't have sort of the foundational stuff taken care of.

The other things that we're seeing here is accelerators and incubators. They're beginning to recognize that capacity building is necessary for a lot of small businesses. It's one thing to provide access to capital, but it's another thing to provide financial training. So we're seeing a lot of NGOs are leaning into that.

Also, the accelerators and incubators, the awards seem to be sticking up a little bit. It's one thing to have a pitch competition and give a $1,000 award. It's another thing to have a pitch competition and give a $50,000 award. So the spike in the awards was very noticeable from my perspective.

Then the last thing I'll mention is, at least here in the State of South Carolina, there seems to be a number of organizations who are concerned about the fragmentation of the resources that are available across the state in the region. What I mean by that is, we have capital providers who are siloed. They're only providing to one group of folks or one area of the state whereby NGO's, they have grants that they want to award out, but they're very siloed as well.

We're going to be talking about the SBIC Program here, we need to add that in. There seems to be a willingness to now bring all of these capital providers together in a centralized space, so I as a small businesses owner I create a profile. Now I have access to all the capital that is available across the state, and not just based on my social network. So I'm very excited about the work we're going to discuss here with SBIC, because I think it will also inform the work happening here in the State of South Carolina.

Thank you Erica.

MS. DUIGNAN MINNIHAN: Thank you so much Herbert. Really appreciate that. Next up we have Laura.

MS. NIKLASON: Hi. It's great to be here. I'm not going to say anything that's dramatically different from what's already been said. My point of view is from the standpoint of a public company. We're considered a small cap company. What I would tell you is consistent with what you've been hearing from everybody else. I think that dollars for equity, dollars for buying shares, are very scarce right now, even for a publicly-traded company with good news flow.

What's easier to get is various forms of debt instruments, whether it's venture debt, whether it's convertible debt that may convert into shares at some point in the future. But I do think the interest rates have driven a lot of capital over toward more debt instruments and more sort of fixed income that a lot of cash is sitting there. It's not that there isn't cash. There is a ton of cash sitting in some of these firms. In fact sometimes we're chased by debt -- by lenders because they want to deploy the capital that they're sitting on, but they don't want to buy equity.

Whether it's a combination of the Covid upheaval combined with the ongoing sort of political uncertainty that we have right now. I think it's making capital in general stay away from equity and really favoring more toward debt.

The fact that most of the equity that is getting invested right now is in AI, I mean surely that pendulum has to swing. I mean, surely there's irrational exuberance now and it will swing back. And maybe one of the benefits from that in a year, after we get past these elections, after people realize that AI is not going to transform the planet immediately, it may be that some of that equity capital flows into other businesses.

So maybe there is kind of a light at the end of the tunnel as interest rates come down next year and as the irrational exuberance around AI sort of tempers. But right now people want to lend you money, but they don't want to buy shares in your business.

So I think if we can provide examples or guidance on sort of novel debt structures that might be more suitable for small businesses, that might be a contribution we can make.

MS. DUIGNAN MINNIHAN: Absolutely agree with Laura. Thank you for that. Jasmin?

MS. SETHI: So I'm going to speak from the perspective of information because I, my consulting work, I do a lot research in small business landscape. And I've been working with companies that want to do philanthropy to help with small business sort of growth, small business financial security, small businesses actually employ I think it's about 50 percent of the workforce. And so that security of small businesses affects the security of our workforce.

I think one of the big things that has been coming out of the research as a constant theme is the lack of centralized information and sort of technical assistance to make the most of the resources that are out there. This is kind of in the vain of Commissioner Uyeda's thinking kind of beyond the SEC and more sort of across Agency, maybe even requiring congressional action, but within the Federal government alone there are a lot of resources. Grants.gov is a great resource for centralized information about grants. But there is a lot of other, I guess we could say resources, different regulatory schemes, that businesses could be taking advantage of but they may not have the wherewithal to do that effectively.

So different regulatory structures as we're learning about the SBIC's today. Different contracting opportunities, there are some preferences for small businesses there as well. But it takes a lot for each business owner to figure that out on their own, let alone as we've heard about there's different state resources, there's private and so forth.

So at least beginning at the Federal level it would be great to see something going beyond grants.gov. You know, grants.gov plus, that is kind of a Federal clearinghouse that kind of shows small businesses what resources, opportunities, etcetera, they could qualify for based on their business. And that may be something that's a combination of human assistance and AI assistance. But I would love to see some concerted efforts towards that in the long run.

MS. DUIGNAN MINNIHAN: All right. Thank you Jasmine. Aren?

MR. SHARIFI: I've been looking forward to this meeting and thank you for letting me share my thoughts on this topic. I primarily work in the M&A

stage. We also work with early stage companies. In the M&A space we're seeing decreased activity, just general uncertainty in the markets, higher interest rates, kind of echoing what everyone else has said on this call.

There's just been some decreased activity. And I think coupled with that it's led to some decreased valuations for certain companies across certain industries and in certain markets. So this has led to companies, maybe that were looking for an exit or companies looking to raise capital to look at different sources and trying to get a little more creative.

In terms of companies looking to exit, few clients that we've worked in and some others in the industry we've seen, they're looking for strategic partners. They're looking for investors to help with the strategic growth, rather than traditional financing, mainly because money is so expensive and interest rates are so high. So they're looking for that strategic partner.

As everyone else has mentioned on this call, it's difficult to raise the capital. There's less funds out there. So the rounds and the opportunities are less and they're just taking longer to find. So I think we're seeing some of that. We're still seeing some middle market M&A transactions, that's still going strong. And some initial signs of increased activity, we're starting to feel it. So we're staying optimistic there.

But as I mentioned, at the beginning of my remarks, we're also seeing alternate financing sources being leveraged or trying to be leveraged. For example, one thing that we're seeing more and more of our people, and this is to Jasmin's point as well, looking at government-backed assistance, tax credit deals, state and local backed grants or backed financing. So we're seeing more people searching for those alternatives and trying to take advantage of those methods of financing their growth as we work through this time in the market where valuations might be a little bit lower across certain industries.

I think everyone is staying optimistic and trying to weather the storm, but it's like I mentioned, we're optimistic. And I think there is good signs, some signs pointing to increased activity. We thought it would be picked up by now at this point of the year, but hopefully by the end of the year it will be stronger.

MS. DUIGNAN MINNIHAN: Thank, Aren.
Bailey?

MS. DEVRIES: Hi. Apologies all. I'm sorry that I'm joining a little bit late today. I had a couple things going on on the home front with a sick child. So I think I will hold off on comments until I'm ready to start my remarks since I haven't been privy to the comments that have been made thus far.

MS. DUIGNAN MINNIHAN: No problem. And hope the baby is all better. All right. Next up, Marc.

MR. SHARMA: Thank you Erica, and I thank all the members for your valuable and often sobering insights. The only thing I would add is from the investor perspective, if you all are interested in hearing from the SEC's Investor Advisory Committee, they are holding a public meeting on Thursday September 19th in person at SEC headquarters. So if you're in town please feel free to attend the meeting in person. The meeting will also be webcast. And once again that's Thursday September 19th. Thank you, Erica.

MS. DUIGNAN MINNIHAN: Thank you, Marc.
Dennis?

MR.SUGINO: Can you hear me?

MS. DUIGNAN MINNIHAN: We can hear you.

MR.SUGINO: I am not the best person to speak on this subject. I have been an entrepreneur, small business owner for 20 years but my business is not capital intensive. I'm in the institutional investment consulting business.

So I've either been blessed or otherwise in not having to have a requirement for substantial capital fundraising in my business. But it is an area of interest, and I know of fund managers that could use a capital infusion and so this is an area of interest for me, particularly for minority fund managers. So I look forward to hearing more on this subject.

MS. DUIGNAN MINNIHAN: Thank you so much, Dennis. Wonderful. And I think we've covered everybody in attendance. I'll just finish up with some thoughts.

In reference to what Chair Gensler mentioned about the impact of rising interest rates on the market for small businesses capital formation, we're absolutely seeing that impact from the demand side. We saw very strong demand from LPs and other accredited investors and qualified purchasers for venture capital product over the last sort of five to 10 years in a low interest rate environment as a result of the fact that their portfolio construction demanded the product with typical sort of endowments and other large institutions that are trying to achieve minimum 5 to 10 percent annual return.

When interest rates are incredibly low they typically need to add some alternative asset higher yielding higher risk product to the portfolio in order to synthetically construct those 5 to 10 percent target returns. Once we see that sort of available in the risk-free and much lower risk market their demand for the venture capital product declines precipitously.

So it's a combination of portfolio construction changes, along with the fact that there has been limited liquidity in the M&A markets and other exit opportunities. We definitely have seen kind of the incredible reduction in the distributions available for LPs and other institutional investors to reinvest into new funds. And then we're also seeing a bit of a bottleneck in the fact that even fund managers who would have expected to have passed their portfolio companies onto the next stage are having to devote a lot more time and energy to their existing portfolio who are not necessarily being able to successfully do follow-on rounds at higher valuations, and require more work from investors to hopefully get to cash flow positive or some other element of sustainability.

So we're definitely seeing a very different market. I would say that since last year we saw some capitulation in the form of startups that should technically be 100 percent funded with equity, raising debt as kind of like an investor of last resort. But a lot of that debt was raised from investors that we would consider to be offering private credit. So a little bit more of typical equity-style investors that thought, hey, we'll structure this at debt to sort of bridge you to an equity round that we expect to happen in the next year or two.

The year or two has come to pass. The availability of capital in the equity market hasn't changed. So we're actually seeing lots of small businesses that had sort of taken that risk last year of borrowing money in non-convertible debt structures from investors have to figure out to execute restructuring and get people into more appropriate equity products, otherwise face their businesses going under, since these debt holder in general have no interest in sort of taking over the assets of the company and running the company going forward.

So there's been quite a lot of action. Some changes in what securities we're seeing used. Absolutely agree that people have been happy to issue securities, cold debt securities, but when there's no path to repayment of principle and interest, technically they're effectively equity securities. I think we're going to see some capitulation in the market in the next year, as well as possibly a wave of restructuring and/or bankruptcies for smaller companies.

So those are a little bit of my thoughts. I want to thank everybody for the amazing insights and give you a well-deserved break until 11:00 a.m. Thank you.

MS. HASELEY: I think we can begin again.

MS. DUIGNAN MINNIHAN: Thank you, Courtney. And I'd like to welcome everyone back. I'm pleased to introduce today's topic, the SBA's Small Business Investment Company Program. SBICs are privately owned and operated investment funds that make investments in U.S. small businesses and startups and are licensed by the U.S. Small Business

Administration, the SBA.

Essentially SBICs may obtain access to SBA guaranteed loans to match privately raised capital, which increases the amount of capital these funds can invest in American small businesses. Obviously there are conditions and regulations surrounding these loans, some of which we'll learn about shortly.

To provide some context and information on SBICs we've invited two speakers to share their perspectives with us and help facilitate the discussion. Our invited panelists will provide an overview of the SBIC program and recent changes, including the introduction of a new type of SBA guaranteed loans to fund private funds, explain the benefits available to an SBIC and address the regulatory framework governing SBICs and share their views on successes and challenges to date.

Members will also hear from our very own member and SBA representative, Bailey DeVries, who leads the SBIC program in her role as the SBA's Associate Administrator and head of Office and Investment and Innovations.

Joining us today we have Kate Price, partner at Winston and Strawn LLP in their Chicago office. And Ms. Price concentrates her practice on representing private equity venture capital and private credit funds in all stages of operations with an emphasis on fund formation and regulatory manners. She has experience with middle market fund managers and leading funds through the SBA's SBIC licensure process. Ms. Price regularly counsels clients on SBIC regulatory restrictions, including representing funds and making SBIC compliant investments in the lower middle market.

We also have Steve Glover, Administrative Partner and Chief Financial Officer at Pelion Venture Partners in Salt Lake City. Pelion Venture Partners is the first recipient of an SBIC license under the newly modernized SBIC program. Mr. Glover was actively involved in that license application process.

Mr. Glover's responsibilities include management company oversight, the fund's financial reports and audits, valuation analysis of portfolio companies, investment allocations and distributions, as well as limited partner communication. Prior to Pelion, Mr. Glover was an Associate Dean and K. Fred Skousen Distinguished Professor at the BYU Marriott School of Business at Brigham Young University. And before that he worked at as auditor for KPMG and later as a director in the U.S. office of Price, Waterhouse Coopers.

Thank you so much for agreeing to give us a great overview of your work today, Bailey. And Bailey, would love to invite you for remarks.

MS. DEVRIES: Thank you, Erica, and thank you to the Committee for the opportunity to share more about this 65-year-old program that we have diligently been working over the last three years to ensure that it is well positioned to meet several market gaps. I would love to set the stage for the discussion with Kate and Steve by providing some context and background on the program. Why was it created. What are SBICs. What are the goals of the program overall.

So I'll rewind the clock, so to speak, to gosh, over 65 years ago, 66 years ago in 1958 when the Small Business Investment Act was established by Congress.

This piece of legislation was in response to a Federal Reserve Board study that found that our private capital markets alone were not adequately addressing the needs for financing of small businesses, both Main Street small businesses, businesses in the manufacturing and critical supply chain as well as the more innovative businesses in research and development and science and technology.

The reason found was that often the risk return profile for investors was not competitive relative to where else money could go. So what was found was that through the application of government guarantees paired with the idea of modern portfolio theory, so having a broadly diversified basket or portfolio of investments that the government guaranteed, that there were opportunities in private markets to de-risk the basket for private investors that would commit funding to those diversified baskets of investments in small businesses, and also increased the potential for returns by pairing the government guaranteed loan with private capital.

I'll give some of the specific language of the Act. I think it's helpful to hear what the mission and intent of Congress was with the program. It was declared to be the policy of Congress and the purpose of the Act to improve and stimulate the national economy in general, and the small business segment thereof in particular, by establishing the SBIC program to stimulate the flow of private equity capital and long-term loan funds, which small business concerns for the sound financing of their business operations and for their growth, expansion and modernization, which are not available in adequate supplies.

Now, all of this provided however, that the policy be carried out in a manner to ensure maximum participation of private financing sources. And then the Act goes on to talk about priority being accorded to small businesses which leads to purchase of equipment and supplies in the U.S., so U.S. orientation.

It goes on to talk about the fact that so long as these funds do not lead to decline or decrease in jobs in a particular area, which the Agency carries out by looking to understand SBICs contributions to net job creation and sustainability.

So I always start with, what is the mission and intent. Many ways similar to how an institutional investor would think about what is the purpose, objectives and goals of the pool of capital that they are managing. Those are goals and objectives.

With that, you say okay, well then how do we do this. So the SBA will license a private fund. And by licensing the fund what we are then able to do if the fund elects to have this, is we can provide them with a government-guaranteed loan to match the private capital that they raise.

Over the past 20 years or so, we have had one form of government guaranteed loan called the Standard Debenture, which requires that fund to pay interest semi-annually on the loan to the SBA. All that is required to be paid back to us is principal and interest. However, that interest was required to be paid semi-annually. So what is the issue?

Well, when you have to pay interest semi-annually there's a need for cash flow to be generated at the fund level. This works well for private credit and mezzanine debt strategies, structured equity strategies that might have a current pay component. But it does not align with the cash flows of longer duration strategies such as equity oriented fundings like early-stage venture, expansion stage, growth equity, what I call buy-and-build strategies over the long term and fund different strategies.

Now I call back the mission and intent of Congress, which was that SBICs be positioned to provide both equity capital and long-term loans. So we found it quite necessary to seek to understand from the market whether there was a need for an additional government guaranteed loan instrument to better match the cash flows of these longer duration funds. Low and behold the feedback was, yes.

We need to have another government-guaranteed loan instrument on the shelf to be able to support and align with longer duration equity-oriented funds. So I'll fast forward to say, that was a big item that we looked at over the last couple years and have implemented as of last August 2023, and you'll hear more about that from Steve. But bottom line now is that the Agency is well positioned to be able to provide funding in the form of a government-guaranteed loan at a low cost to funds across the spectrum of financing in the private markets.

Now, there are certain conditions of the financing that I would love to go over because the program is focused exclusively on the small business segment and on U.S. small businesses. But before I get there, I'd love to share some statistics about what the program has done within this area.

So over the 66-year history, SBIC licensed private funds have invested more than $160 billion in U.S. small businesses and startups, including some of America's most iconic companies that many folks will know as brand names, Apple computer, Tesla, Whole

Foods, Intel, FedEx, Staples -- many great brands that without an SBIC to provide them with financing may not be contributing to the economy the way that they are today. So they started small but grew to giant.

With that, the impact across the program has been quite broad. We have as of the end of the fiscal year over 318 private funds that are licensed as SBICs. And that is across 240 firms. The program has over 42, close to about 43 billion in public and private assets under management. So both the SBA government guaranteed portion as well as private financing, 70 percent of which comes from banks and the rest from institutional investors and high net worth individuals. It's about a 50/50 split between SBA's funding and the private-market funding.

We recently were approved by Congress to commit up to $6 billion a year in funding to SBICs from the SBA, was $5 billion the past two years and $4 billion the year before. Last year alone, SBIC funds were responsible for providing $8.1 billion of financing to U.S. small businesses. In total SBICs last year financing over 1,900 U.S. small businesses. And last year alone were responsible for creating and sustaining over 130,000 jobs in the small business segment of the U.S. economy.

I will share, as of the end of last year only 870 businesses of those 1,900 received equity-only financing. So again, to the point around a need for another government-guaranteed loan instrument in the SBIC program.

I will also share that an interesting thing about the program is that it is considered to be a federal credit reform program. What does that mean for everyone?

Guess what, it means that Congress does not need to appropriate funds every year. So the program does not cost taxpayer dollars in an outlay of appropriation every single year. How we're able to do that is, by insuring that we have a portfolio of funds that are able to repay the principal and interest. And then we have a small fee that managers are charged to help provide a buffer in the event there are any defaults or losses.

Now the great news is, for the last quarter century the program has not cost taxpayers any dollars as a result of successful repayments of principal and interest, strong performance of the funds, and very low levels of failure to pay back the SBA. In fact, over the last 24 years, less than 5 percent of SBICs have failed back to pay the SBA in full. And of that less than 5 percent, those that may not have paid back in full, in time over half of those have been able to pay back but just at a later date. So often there's a refinancing that's available as a result.

So from there I'd love to also share a little bit about how the program works. So we said we license the funds. So in many ways I would think about the role of the SBA in its capacity of being very similar to an institutional investment consultant, where we are performing due diligence up front. So they will complete something called a management assessment questionnaire, which is akin to a DDQ, a due diligence questionnaire, that a manager may complete, providing information on track record, on the investment thesis strategy, portfolio construction, as well as the operational and legal aspects of that fund. So our licensing process in many ways is like a due diligence process.

The one thing I would point out is, that if a fund is eligible for the program, we then move forward with providing the license and will determine, based on the various factors but predominantly looking at the risk return profile, portfolio construction and other objectives of the fund, the amount of government-guaranteed loan funding that we can provide to match the private capital.

As I mentioned, we have two instruments today, one the Standard Debenture and then one called the Accrual Debenture. The Accrual Debenture is used for equity-oriented direct funds and also used for a fund-to-fund license that we have as well, called the investor license. And the Standard Debenture aligns with any funds with more of a current pay component. So frequently again, that's debt, private credit, structured equity strategies.

So with the Standard Debenture the SBA is able to provide up to two times the match of private LP capital committed to the fund at a max of $175 million per fund. With the Accrual Debenture, the SBA is able to provide a match of up to 1.25 times the private capital, again, at a max of 175 million per fund.

Now the SBA, we do not get involved in any of the investment decisions of the fund. Once you are licensed, our job is to monitor the performance, be a supportive partner to insure that regulations are being followed, and undo risk is not being introduced to any sort of regulatory concerns. So we monitor the portfolios and we support call down of the loan, what we call the draw down of the loan, and manage the relationships with those managers.

And then we are the primary regulator of these funds. SBA is the primary regulator. We will license SEC exempt funds. We also will license funds that are registered, as well, but predominantly exempt funds. For those funds that do take funding from the SBA in the form of government-guaranteed loans, we perform regulatory compliance for those annually. For those that do not take funding and merely would like the license, we will perform regulatory examinations biannually.

You might say, why would somebody want to be licensed as an SBIC and not receive funding from SBA. Well, there's a lot of good reasons but the primary one cited is, that SBICs are considered by the bank regulators to be public welfare investments PWIs. And they're eligible for CRA credit. And in the new CRA regulations that go into effect in January of 2025 there's a presumption of qualification of SBICs for CRA credit. So what does this do?

It opens up the banks as a channel for LP capital to private funds, which is often very attractive to a lot of fund managers. Additionally, since there are not taxpayer dollars at risk for the funds that we do not provide capital to, the underwriting standard in terms of return and exit expectations and track record is not the same bar as it is for those funds that are applying for government funding where we have a need to ensure that the capital is paid back to the government, both the interest and principal. So it is a way that oftentimes some funds will start with the program if they do not have a robust track record.

In terms of eligibility, a fund has to comply with our regulations. I won't get into everything specifically, but I'll call out some of the big points. So the fund must manage a diversified basket of investments. So minimum of 10 companies typically, although on average you typically see 20 to 30 portfolio companies in that basket to diversify risk potential. The fund needs to be focused on investing exclusively in U.S. small businesses and what we call smaller enterprises. The definition of what's a small business and a smaller enterprise is based on the U.S. Small Business Administration's small business size standards.

The program, a great thing about it is we have an alternative size standard based on the net worth of a business or we have the Agency's set of standards based on the industry's codes. For example, in some industries such as manufacturing, the small business size standard may be based on employee head count. So it might surprise you what is considered small. But essentially if you look at new business starts, you look at the lower end of the middle market, the majority of businesses in the U.S. qualify.

Then of course is you have to have a cohesive management team. The ability to be compliant with SBA regulations, background checks, and have experience in managing the type of investment strategy that is being proposed. So it doesn't necessarily have to be fund 2 or 3 at your firm. It could be your first fund. It could be a team spinning out from a larger platform.

We do not require a certified track record from a past employer. We do our reference checks and review track record. Not every single principal of the fund has to have had the investment experience. Sometimes with a new fund, a lot of the risk is on the ODD side, the Operational Due Diligence side. And having an individual that understands how to start and build a business, since that is what you're doing if you spin out a referral, is incredibly valuable when paired with an experienced investor.

But there does need to be evidence of a track record indicative of the strategy that is being proposed and some exits. It's a different track record requirement in terms of exits versus markups, depending on the investment strategy that is being proposed.

And then I'll also share that sometimes individuals would spin out of a firm and may partner up with an experienced SBIC manager to have a principal of an existing SBIC on the investment committee of the new fund for like what we have as our emerging manager collaboration, which is a great way for individuals that might have as much experience to be able to pair up with individuals that know the program well to help firms get their start. So something we're very excited about and have been very pleased with the results of the emerging manager collaboration.

So as I mentioned, there's a range of licenses that we offer now underpinned by two types of government-guaranteed loan instruments, the

Standard Debenture for private credit structured equity or mezzanine. And then the Accrual Debenture for venture growth, buyout, other long duration strategies, the re-investor SBIC, which also uses the Accrual Debenture, which think of as the fund-to-fund SBIC where we license the fund-to-fund but then in turn invests in non SBIC funds to help seed them, help emerging managers get their start.

Although that re-investor SBIC can invest up to 50 percent of its portfolio directly in portfolio companies, as well. We see this as a novel way to create more networks and pathways to follow on capital for some of those emerging managers who may not have as robust a network. So we have safe harbors for the re-investor S space to invest in the value track input portfolio companies of the underlying manager.

And then lastly, as I mentioned, the license where SBA capital is not provided, which we call non-levered SBIC. I'll talk a little bit about the process and then I'd love to turn it over to Kate, as well. I think she had a fantastic perspective from the fund formation role perspective. And then we can take some questions.

We also revised our licensing process with the introduction of the new government guaranteed loan instrument based on some great market feedback. And our goals and objective of revising the licensing process were for essentially SBA to be in a better position to wear the hat of an anchor investor. So while we're not an LP, we often are providing 50 percent or more of the capital that the fund is utilizing for investments. So we are similarly situated in many ways. I often say, we're like an LP with a lower return expectation, which as a result leads to more of the returns, more of the profits, going to the limited partners and more downside risk protection.

So with that, we updated a process where previously it was not always clear how much capital SBA would provide to a manager. And we often would not perform legal due diligence, review limited partnership agreements, general partnership agreements, management company agreements, until you were ready to have your close. So we had a sought to improve called the customer experience, with our partners. With that our process is the following:

A manager can download from our website what we call prescreen max or prescreen management assessment questionnaire, which has some of the basic information that would be required in the full management assessment questionnaire, such as track record, full narrative of the fund, bios of the principals of the fund, and that can be submitted to SBA for no cost.

And then the SBA will review that document and conduct a pre-screen call with each manager to ask questions, also give an assessment of whether they might be called SBA capital ready or provide some suggestions around a path to get to yes. I think in the process different opportunities and to potentially work with us. But again, we lift up different considerations, things that we've seen work in the past up to the manager. We do not get involved in their decisions around structuring, investment strategy, etcetera.

If the manager then would like to proceed, we have four quarterly filing windows at the end of each fiscal quarter. So end of March and June, September, December, where applications can be submitted. And then from there we start the due diligence process of reviewing the materials, doing interviews with the manager, doing referral calls and preparing investment memos to bring to investment committee for a decision about whether or not to bring the manager in for an interview.

If we do move ahead with an interview we vote on what we call a green light. What is a green light? A green light is the Agency saying we have completed operational and legal due diligence and here is the dollar amount max that SBA is willing to commit, assuming no material adverse changes to any of the documentation, the team, the strategy, etcetera, between the receipt of the green light approval letter and that fund moving ahead with a first close.

When the fund is ready for a first close they come back to us with final versions of their documents, any red line changes, they would pay a final licensing fee, they would call down initial investor capital. And we would approve the license, provide the license number. And the fund could start drawing down SBA capital to begin investing in small businesses.

So then you're licensed -- then throughout the life of the fund the fund would be required to provide transparent reporting on a quarterly basis to SBA in terms of fund financials, as well as, information on portfolio company investments. They're a way of protection against all of that. We do not disclose individual information on company investments nor do we disclose information associated with that fund manager. Performance at a fund manager level is not disclosed.

All LP capital names are also not subject to, fine China, I always say, and protections around this. Our goal is to ensure that we are doing what we can from the public sector and to again encourage and stimulate private capital into small businesses.

Typically funds have a 10-year life. Sometimes they go a little bit longer and our government guaranteed loans from each call down or draw down, have a 10-year life. So think about, if you are drawing down capital from SBA and you're afforded the fund, that is when that money will need to be paid back. If there's high residual value and the underlying assets are performing and strong, with enough notice the agency is of course always willing to discuss refinancing or rollovers. We want to stay aligned and do what is in the best interest of the small business portfolio companies and the financial success of SBICs.

So I'll close there. I know I may have been a little bit long in, it is not the simplest of programs, but one that has been extremely successful and made a tremendous difference in terms of giving the flow of capital to sustain and create small businesses in the U.S.

MS. DUIGNAN MINNIHAN: Thank you so much. That was an incredibly valuable overview on a very complex topic. And we very much appreciate the tremendous amount of work and thoughtfulness and effort that the SBIC has put into creating this program in support funds that invest in small businesses. So thank you for that overview. I would love to open it up for a few minutes to Q&A from the committee.

I would love to start with a first question around newer funds, you know, emerging managers, even if it's not necessarily a Fund 1, a Fund 2. So what I believe, what I thought I saw from my initial review of the product is that there is a requirement around having actually had DPI in the previous fund, so some exits and distributions back to investors which we know for earlier stage funds can often take a few years, I would say a minimum of three, more reasonably about five years before they start returning capital.

So that sort of lead time combined with what I was told is an estimate of about 12 to 18 months to actually get the license process, how does that kind of line up with suitability for sort of emerging managers, hopefully on Fund 2 or Fund 3, and is there anything that the SBA is doing to mitigate that effect? I think you had mentioned something around exceptions for requirements on exits or distribution or track record.

MS. DEVRIES: Those are excellent questions. I'm really thrilled that you asked that because we have emerging managers that are listening here today. They're near and dear to my heart. I'll tackle it a couple ways. First I'll talk about the licensing times.

When I joined three years ago, one of the first things we talked about as a team was how can we speed up the licensing time frames. Thinking about things also from the fund manager's perspective, they're not just thinking about our steps in the process and how long we're taking. But they also are factoring in how long it will take them to raise capital.

Often we found that was the longest amount of time. So I go back to the big change in our process around our doing investment operational and legal due diligence up front on everything and providing a conditional approval of everything at the time of green light. And then also stating the amount of money that we are in for. And having a document out there that has been approved by the SBA administrators, so cabinet-level documents, we are committed to X amount of capital so long as there are no material adverse changes.

I couldn't think of anything more support of a fundraise than having that assurance and knowing that all of those legal boxes were checked thoroughly in advance. We are hearing great feedback from fund managers that that is in fact speeding up their fund processes and then they're not waiting on us to do any additional work if they don't have any material adverse changes. So definitely shrinking the licensing time quite dramatically.

Also, by virtue of not stacking activities such as doing operational due diligence and investment due diligence and doing legal at the end we're conducting these activities simultaneously. We have increased our head count in terms of our fund formation attorneys in house and legal as well as the number of investment analysts on our licensing and due diligence team. So that's a great effect there.

Our goal that we are striving for is to get to a point where as long as there's no issues from the managers, so the manager can control speeding up or slowing down the time, that we get to a point where when a manager applies at the end of a filing window, that within the next three-to-four months we are done done wrapped and ready to go and those green light letters are issued. And then it is in the manager's hands around the fundraising timeline.

We have seen great progress towards already seeing licensing time shoot down closer to six-and-a-half to seven months under the new process. We are still processing some legacy applications under the old process. I certainly would like to acknowledge that as well. We are aiming to be through all of that by the end of the fiscal year. So thrilled to that result.

Now to the point around DPI, so I often think about the fact that there is no one size fits all. So what you see in a mezzanine debt strategy, private credit, buyout versus C stage or early stage ventures, equity, very different expectations around the time horizon to liquidity. So we evaluate them based on the strategy that's being put forward.

When we look at a fund manager that has a track record in the seed stage, we would not expect to see as many exits or exits for partial liquidity of the fund, as for somebody that is running a mez debt strategy.

So it does vary. We'll look at a different mosaic of factors. We'll look at markups. We'll look at comparables. Really seek to understand the story. Although, if we are going to provide capital, if we are going to use one of our government-guaranteed loan instruments, there is an expectation that there is some evidence of the manager having successfully managed from, I'll call it cradle to grave, of having put the money in the company and been there to support it. But it doesn't need to be a ton of them. Otherwise we would be waiting forever for venture managers.

Now I would say, this goes back to a few things I talked about before. The first is the emerging manager collaboration. There are a number of phenomenally talented individuals who have spun out of firms and they have made investments and because companies are staying private longer, as we often talk about and not necessarily seeing the same number of public market exits, and also in this interest-rate environment as pointed out earlier in the discussion that M&A environment has slowed.

We have voiced that we're very supportive of some of these individuals, very high potential that have a lot of experience in terms of getting the money in the companies, and starting to work on the boards and help them gain product market fit, get customers, build networks, hire talent. For those individuals to seek out mentor and other experienced investors to sit on their investment committee.

Not necessarily saying those other individuals have to have ownership in the firm, but really to think about a way to strengthen networks and have some support. And that way the track record of that other individual will be factored in in the application. So I think that is really just an elegant way to approach the program.

The second, I very often put myself in the shoes of an individual that is seeking to build a small business, build a firm, and time and money are very precious assets. And many folks might not want to invest that time and money working with a heavily regulated federal program. For that reason, often will go to fund-to-funds or family and friends or high net worth investors, to get their initial capital to launch a smaller fund.

So with that, our novel approach to

supporting one micro fund across the company and emerging managers, which we very much believe we need and we seek out, because if there are more capital allocators in different communities and different geographies doing different types of investing we'll reach more businesses.

So with that, we established the re-investor SBIC, where we can license a fund managed by a larger asset management platform that has experience as a fund investor. And then that Fund of Funds that we licensed is able to be supportive of those first-time funds.

Some of them may go on to be SBICs. Some of them may not. But if you have an interest then we started to create the mentor networks, the ability to create knowledge transfer, understanding of regulations, compliance requirements, and we are doing step removed, but we are doing actions, taking actions to have more small micro and emerging manager funds across the country investing in the U.S. small business and startup economy. We're very much looking forward to seeing how that program grows and the fly wheel that it will kick off.

MS. DUIGNAN MINNIHAN: Great. Thank you so much Bailey. This was wonderful. And I apologize, looks like we're running out of time for more Q&A from the Committee, but I think we covered a lot of really really important points. Thank you very much.

That was so educational and I'm sure the entire audience is grateful for you sharing your knowledge and detail on the program. And we're also, I think just really incredibly impressed by how thoughtful the SBA has been in making sure that this program fits a diverse array of managers across asset classes and level of experience. So thank you.

Wonderful. So next up I'm pleased to invite Kate Price, Partner at Winston & Strawn, as our next speaker. Kate.

MS. PRICE: Great. Thanks. Happy to be here. As mentioned my name is Kate Price, I'm a partner at Winston & Strawn in our private investment funds practice. My practice focuses on representing fund managers that in turn invest in the lower middle market, and in particular an emphasis on fund managers that apply for a licenses as SBIC funds. So I'm grateful to the committee for taking time to focus on SBICs because I do think they are such an important part of the small business capital formation market.

I think layering onto the conversation at the beginning in terms of market, I think SBICs are more vital in today's capital markets than perhaps than ever. And then, after giving a few kind of more high level remarks on that I can move in again to some of the regulatory framework that Bailey mentioned. I'm happy to get into more details and answer questions.

In today's market, as mentioned, with the steep rise in interest rates we've seen elevated borrowing costs and as a result we've seen banks, in particular, small and regional banks increasing their lending standards. And we've also seen many companies putting their own growth initiatives on hold given that higher cost of capital. So just echoing what many on the Committee observed. We're certainly seeing that in the private fund markets as well. In addition, in terms of private funds, we've seen a growing trend for private funds to grow in size and move up market.

So as individual funds are raising larger and larger amounts of capital, the average check size is the average investments that those funds are making, are also increasing, which leaves them better matched to larger companies that are needing more capital. And also increases that void for those smaller businesses and from particular businesses on the lower end of the middle market, with banks pulling back and funds getting larger, that gap is really becoming broader from our perspective.

I think in addition to that, just the overall lack of liquidity in the markets and as somebody mentioned, the rebalancing of many of the institutional investor portfolios are further exacerbating that challenge for smaller businesses to get capital. From my perspective, SBIC funds have historically, and now with this regulatory reform will have an increased ability to fill those voids in the market.

As was mentioned, historically SBIC funds have already deployed more than $160 billion to U.S. small businesses and they're currently licensed over 300 SBIC funds. With the regulatory funds that Bailey spoke about, the SBA really does stand poised now to license more SBIC funds than it has in the past, and funds with more diverse investment strategies. So in particular are the funds that she mentioned that in turn invest in earlier stage companies or venture funds or growth equity funds. We expect to see and have already begun to see with these new regulations, more of those funds licensed, again, filling that gap in the market for those earlier stage businesses.

Bailey shared little bit and I suppose I would just echo in part how we came to these regulatory reforms providing my perspective from the industry, and also just observing that under the leadership of SBA's Administrator Guzman and then Bailey and the entire team at the SBA, the regulatory reforms that were implemented, not just created a new financial instrument, which they did, but really it was the most extensive reform of the SBIC program that we've seen in several decades.

I think it was done quite smartly. Meaning that, as Bailey shared, what they did in designing this was first to step back and internalize what is the mission of the SBIC program. And if the mission is to get capital to underserved businesses, there was a piece of that puzzle that was missing. So the accrual debenture instrument that they created is much better suited for those funds with earlier stage strategies. Since the program went live and started accepting applications last September 30th, we have seen a number of venture funds, growth equity funds and earlier stage strategies seeking out the program for the first time. So I do think the instrument created has had traction in the market and is being picked up.

I think that it's also important to note that even prior to the launch of this new financial instrument, SBICs were already a pretty critical part of getting capital to diverse small business owners. At the end of their last fiscal year, so fiscal year 2023, about a quarter of SBIC investments were in women-owned, minority-owned, veteran-owned businesses or businesses in low or moderate income areas. So SBICs historically have invested at a higher rate in these underserved businesses than their non SBIC peers.

Back in 2017, so a little bit of time, the Library of Congress did a study that also found that the SBIC-backed businesses created approximately 3 million new jobs for our country and supported an additional 6.5 million jobs over a 20-year period thus currently has been magnified since 2017.

So I think sometimes with these outside statistics in terms of capital going to underserved businesses and the creation of jobs, sometimes we hear about whether SBIC funds have poorer performance than their peers or at what cost these programs are being provided in terms of the taxpayers.

Bailey mentioned this but it's really important to double down and highlight that the SBIC program operates at zero subsidy to the U.S. taxpayer and has been that way for a very long time. This is one of the very successful examples candidly of a public private partnership. I think it works, and again, with new tools and tool kit we expect to just see this magnified.

And the second, from the return's perspective, SBIC funds actually outperform both their non SBIC private fund peers as well as public benchmarks. The Institute for Private Capital recently published a report and they looked back at a 20-year period, so from 2000 to 2020, and that report found that on average all SBIC fund types at all different leverage levels demonstrated superior performance when compared to their non SBIC peer group.

They found that an average of about 4 percentage points better in terms of IRR per peer group. An average of .74 times better as a multiple invested capital. So I share that because, again, sometimes people assume that this is such a mission-focused program, that to invest in them is a tradeoff and that's actually not the case.

From my perspective having worked in this industry for over 15 years, I think the success of the program is a combination of a rigorous licensing process. Bailey touched on that a little bit. But the process they go through and the due diligence they do insure that high quality fund managers are the ones being admitted to the program.

On the other side, I think they have a very balanced regulatory framework. So there's a balance between allowing funds enough freedom to operate to tap into the insight and ingenuity of the fund managers to find good investments, to find good companies, to grow those companies, and at the same time, there's sufficient regulatory compliance and reporting obligations and oversight from the SBA to ensure that there's a responsible use of those government-backed funds.

So I say that all by way of background. Happy to turn and summarize a little bit of the specifics in terms of the regulatory framework that SBICs operate within. I think Bailey and others have certainly laid out perhaps the obvious, but the benefits of being an SBIC fund. These are privately managed funds licensed by the government. And as Bailey went through, there's different leverage types.

There are the unleveraged funds, and as she highlighted we often have people say why would anybody be in an unleveraged SBIC. I don't understand that component of it. But being an unleveraged SBIC really opens up investments from banks into the funds. So even prior to the launch of this accrual debenture instrument, which again is better suited for venture funds, we would have a number of venture fund managers that would be licensed as an unleveraged SBIC fund simply because they had banks that wanted to invest and the investment in an SBIC fund provides the bank with an exception from the rule as well at that community re-invests in that credit that Bailey mentioned.

On the other side of the house, the standard debentures, which are the debentures that have been around for a long time and the accrual debentures. Bailey went through some of this so I'll just touch briefly but ten-year maturity, interest only -- excuse me, semiannual interest on the standard debentures.

And those standard debenture funds, so think credit funds, can apply for up to two times the private capital that they raise, up to $175 million cap per funds. Those loans are not amortizing. They can be prepaid at any time. And the funds that are licensed with the standard debenture can make distributions of what we call READ, Return Earnings Available for Distribution, as profit distributions without any concurrent payments to the SBA.

In addition to that, they can distribute up to 2 percent a year of their regulatory capital. And then thereafter need to work with the SBA for an approval plan on paying down the SBA debentures as they make distributions to their LPs. Obviously on that side, the standard debenture instrument has the vast majority of the funds, licensed there are you senior dot funds, your mezzanine dot funds, a lot of credit strategies. Some buyout funds live in that program but you do need to have some element of current pay in the portfolio.

So then shifting gears to this new accrual debenture instrument. It's also a secured note. It also has a 10-year maturity, but importantly, as Bailey highlighted, there are no interest payments due on that note for 10 years. So that lines up better with investment strategies that don't necessarily have current pay. So we're seeing a lot of venture funds and growth equity funds apply to this program.

On this side of the house, the leverage ratio can be up to 1.25 times whatever private capital was raised by the fund, so slightly lower ratio, just wanting to insure the risk in the portfolio is appropriate. Similarly they're capped at 175 million per fund, less in interest reserve.

I think it's also just important to highlight that the SBA is not a limited partner in these funds, not in the standard debenture funds and certainly not in the accrual debenture funds. And they don't share in the profits. That's sometimes a miscommunication in the market. There were previous initiatives within the SBA that were structured differently from this. So I do think it's always important to note that the SBA is not a limited partner and they are not taking part of the profits from the funds.

So even on the accrual side, when the fund wants to begin making distributions to its investor what is required is that first, they catch up on the accrued interest on the loan and pay the fees. And then after that they can begin making distributions to their investor as long as they're paying down the no pro rata. So if you had the fund that got the full 1.25 times its private capital, essentially for every dollar you're distributing to LPs you're needing to pay down the principle on your outstanding loans a dollar and a quarter for each dollar that goes to your LPs.

Bailey mentioned this, but again as part of this regulatory reform, they also opened up licensure for the first time to what they call reinvestor SBICs, Fund of Funds SBICs. That again, is an interesting way for there to be a hub and spokes approach, so to speak. Meaning that the SBA licenses are Fund of Funds and then in turn that's where they hope and expect to see many of the more emerging managers, earlier stage managers, that those Fund to Funds in turn invest in.

The funds that they invest into then have the requirement that they invest in U.S. small businesses. So tying back to that key component of SBICs making sure this government-backed capital is supporting U.S. small businesses. But I think that's an interesting addition to the program. And I'm excited to see where that goes.

I also wanted to mention roughly the same time that these new regulations came out the SBA announced a partnership with the Department of

Defense where the SBA is going to license what they call critical technologies funds.

Those are funds that have an investment strategy that includes investing at least 60 percent of their capital into companies that are either directly involved in critical technology areas, those are areas that the DOD has announced are critical to the success of our country. So either directly involved in those critical technology areas or they can be companies that are somehow in the supply chain's component part processes of those critical technology areas. Those CT funds, as we call them, can either use the standard debenture if that's appropriate for their investment strategy or they can use the accrual debenture.

So shifting a little bit to the instrument itself, the debentures are priced, the interest rate is priced based on 10-year treasury notes and usually have a market-driven premium over that price. The most recent pooling of the standard debenture side was at 5.035 percent. The accrual debentures have obviously just begun to be issued, so they haven't yet been pooled and sold to the market. But we do expect them to be pooled and sold separately from the standard debentures.

Moving into what are the regulatory restrictions. We sort of laid forth the benefits of this inexpensive leverage, the ability in these very tight fundraising markets to double or triple the capital that you have to deploy, but what do you have to be comfortable living with if you want to apply to be an SBIC fund?

So you do have to commit to investing exclusively in U.S. small businesses. That has a definition that is based on, as Bailey mentioned, either tangible net worth and -- I can give you the specifics. But tangible net worth of 24 million or less and average net income after taxes of $8 million or less for the preceding two fiscal years. That makes you a small business. Or you can also qualify under those NAIC codes that Bailey mentioned.

So all of your investments need to be in small businesses. But in addition to that, at least 25 percent of an SBIC's financing need to be in what we call smaller businesses. So those are businesses with net worth of less than 6 million and average net income after taxes for the preceding two years of not greater than 2 million or again, fit within those NAICS codes. So there is a component of trying to ensure that at least a certain part of SBIC's capital is going to smaller companies.

Now there is basically a usury provision within the SBA. The SBA does limit the amount of interest that you can charge portfolio companies. We haven't seen a lot of pressure on it in markets of late but, for a straight loan to accompany the cap is 19 percent. And then if your loan has some type of equity component like a warrant or something like that, the cap is 14 percent.

There's also the diversification requirement, which is that you can't invest more than 10 percent of your capital in any one company. And that 10 percent is both the private capital you raise and the SBA leverage that's committed on top of that. There are also some things that SBICs are not permitted to invest in. I think this is important to highlight because we do get calls sometimes from people that have strategies that really aren't a fit for the program.

One, is that other than those re-investor SBICs which have just been launched, SBICs are not permitted to themselves invest in re-lenders or re-investors. So you don't have SBIC funds going out and investing in other banks, other pooled funds.

They need to invest directly in small

businesses. SBICs, in general, cannot interest in real estate projects or single-purpose projects. And finally the one I'd like to highlight is that SBICs can't invest in businesses that have more than 49 percent of their employees or their tangible assets outside the United States.

So that's kind of the hook when we talk about a U.S. small business. It's not more than 49 percent of employees or tangible assets outside the United States. So shifting gears a little bit to look at limitations or restrictions on what investors can become a limited partner of an SBIC funds. There aren't many, which is good news. We actually see a wide swath of investors.

So everything from high net worth individuals, banks, as mentioned, have a lot of investments in SBIC spaces, foundations, companies corporations, others, so there's a very wide LP base. For a leveraged fund you do have to get at least 30 percent of your private capital from three investors who are unaffiliated with your management. There are very limited exceptions but in general they're looking for diversified pool of investors.

It's also important to note that once an investor becomes 10 percent of the SBIC's private capital, that investor will have to disclose its underlying owners. There are other steps along the way where if an SBIC fund -- excuse me, the limited partner, becomes very large, for example, 50 percent of the private capital, that limited partner would have to be comfortable disclosing information to the SBA and doing background checks.

So in general, in SBIC funds, you do see it's not one investor backing SBIC funds, or two, it's a fairly diversified group of high net worth individuals, banks and other institutions. So I do think it's important to note on the regulatory oversight perspective, and this was mentioned by Chair Gensler at the top, but investment managers who advise only SBIC funds are exempt from both federal and state registration as an investment advisor.

And in addition to that, the SBIC assets that they manage, if they manage for example some SBIC funds and some non SBIC funds, the SBIC fund assets are excluded from that calculation of assets under management for purposes of the $150 million private fund advisor limit. But although many of the SBIC funds are not registered as investment advisors, they do have significant reporting obligations and oversight from the SBA.

They have quarterly GAAP valuations that are required as well as filing quarterly portfolio reports with the SBA and information on each portfolio company that they vest into. They're also subject to examination by the SBA. So approximately every 12 months for the funds with leverage and every 18 months for funds without leverage, you have somebody from the SBA and their team coming into the fund and doing an examination and making sure you're complying with regulations and calling out any areas that they have questions or concerns with.

And then depending upon the regulatory violations, seeking ways to remedy that. There are also a few things during operations that SBIC funds are required to seek SBA approval of. In general, fund managers are fairly free, as Bailey mentioned, to go find their businesses make investments, or certain things that trigger SBA approval, including certain transfers of limited partnership interest, amendment to your legal documents that they reviewed and approved.

So not your day-to-day operations, but sort of more extraordinary events you do need to go and seek SBA approval for. I also just like to mention that SBIC funds do have fairly standard economics in terms of private funds. The SBA does cap the management fees that you can charge, but it's a standard cap.

It's 2 percent and in an SBIC fund it's important to know that it's 2 percent of your private capital plus 2 percent of that assumed SBA leverage, so really the full capital base that you plan to invest. And then most SBIC funds have a 20 percent carried interest.

So maybe I'll pause there. I'm happy to go into more detail on the licensing process. I think Bailey gave a nice overview of that. I would just like to echo, it is a rigorous licensing process, but it is one that is there is great guidance on in the markets, talking to peers, going to industry events. And I would encourage anybody that's interested in the program to really look into the process that Bailey mentioned for a prescreen.

It's a unique, I think, opportunity that the SBA allows you to put together, summary cursory information of your team, your strategy, your track record, and actually get in front of the SBA for a 30, 45-minute phone call. They can help. And industry contacts can help, as well, identify things in a strategy that could be problematic before a fund kind of has to embark on that full application and all of the legal documentation associated with it.

I encourage everybody but people that are on Fund 6 SBIC, I encourage everybody to take a advantage of that. I think it's a real opportunity.

So I'll pause there.

MS. DUIGNAN MINNIHAN: Thank you so much, Kate, wonderful. I would love to open up to questions from the committee. All right. I think we have one from Herbert.

MR. DRAYTON III: Yes. Great presentation, Kate, thank you. Just a quick question. Can SSBCI funds be used as part of the match?

MS. PRICE: That's an interesting question. And it guess complicated. There are certain restrictions on the qualified non-private funds and how they impact your legislation. So we have not seen funds with large portfolios in that investment.

Bailey, you might jump in. I know you guys were looking very closely at this and the ability for funds to get leverage on those types of dollars. Maybe you can weigh in from the policy perspective on that.

MS. DEVRIES: Yes. Today how things stand is if a private fund accepts state small business credit initiative dollars, those specific dollars can't counter towards the match. However, the other private capital in the fund, so long as it meets the statutory requirements can. So I would think about it that way. So it doesn't preclude you from being in the program. You can still bring in that capital. But it wouldn't count in the formula for the match today.

There's different legislation floating around The Hill that is looking at this issue. So might be worth looking into what is out there as well.

MR. DRAYTON III: Just one quick follow-up. If private capital is used to secure SSBCI resources, can that same private capital be used for SBIC match.

MS. DEVRIES: Yes, assuming that it is eligible so assuming it would money from a bank or an endowment, foundation, private investor, pension plan, etcetera.

MR. DRAYTON III: Thank you.

MS. DUIGNAN MINNIHAN: We have a question from Bart.

MR. DILLASHAW: Kate, thank you very much for the description. Any sense of what the general cost for a firm to go through this process is, both from sort of the initial application stage and then from the ongoing sort of admin, the incremental admin cost is. And then a secondary question of, through the application process, any sense of how likely you are to actually get something. If you can sort of go through the process. I don't know if there's stats on number of grants or applications. Anything you can give on that.

MS. PRICE: Yeah, sure. First in terms of the cost, as part of the regulatory reforms that went through, the SBA did take an initiative to try to gradate costs. So to minimize costs candidly for our funds that are earlier in their stages of development where there tends to be less capital and more personal risk at play. So there is a graduated spectrum for first-time fund, that initial filing fee, to the SBA is $5,000. And then the final licensing fee is $10,000. That goes up once you're on Fund 2, Fund 3 and Fund 4. The SBA will work with each individual applicant to understand, it's not as simple as the Roman numeral stick after your name, they actually do dig into understanding where you are in the life cycle.

And then the other organizational costs

really come in on the offering side. Going to your investors, working with legal counsel to prepare your PPM and things like that. I will throw out, there is a regulation or cap-in policy right now for the SBA, that organizational expenses are generally capped at 500,000. So for some people on the venture end of the spectrum that sounds very high. For some on the private equity end of the spectrum that sounds very low. I'll leave it to you and your strategies to decide, but that is a current limitation for SBIC funds, a policy of the SBA.

MS. DUIGNAN MINNIHAN: Great. Stacey?

MS. BOWERS: Thanks, Baily and Kate. This has been really informative. You both talked a little bit about the reissuer license. And I think I'm just curious. I know it's new and it's tied to accrual debenture, but are you starting to see interest, and are there any differences for the process for that licensing.

MS. DEVRIES: Kate, do you want to go first about what you're seeing?

MS. PRICE: Yeah. I definitely think there's interest. I mean, I think the encouraging part about is again is this is definitely a new fund manager class and so right now candidly we're seeing a lot of interest in the program and attempting to do a lot of education. So fund managers traditional that are Fund to Funds sometimes have direct funds and are aware of the SBIC program. And sometimes this is brand new to them. So it's really getting their arms around things we spoke about. What are these regulatory restrictions, what are the compliance obligations, how much does this cost, how much time does it take.

So it's really been an educational process, but the initial interest is great. There are currently re-investors that have applied and are going through the SBIC licensure process, so I think there's some tangible proof that some will explore this program. Maybe I'll leave it there, Bailey, and you can add in your perspective.

MS. DEVRIES: You know, we have a lot of conviction and the idea we think it's well-aligned on many fronts. So when you have a fund-to-fund structure you have more diversification. So you limit more of the downside. So that works well for keeping the program zero cost to taxpayers so that's the positive from a public-good perspective and prudent use of funding that's excellent. It also meets the objective of giving rise to more small businesses in the asset management industry by enabling funding to effectively get out and to micro-managers, small managers, managers that are underserved.

So there is a requirement in the regulations to apply for the re-investor license, aka the fund-of-funds license, that your business plan has to have an underserved or undercapitalized focus. It's very much you let a thousand flowers bloom. There are different needs that are underserved based on different parts of the country, different industries, different technologies, different stages of financing.

Our goal is not to be prescriptive, but to put in a regulatory framework in place that can enable increase in private sector participation of investors. And then lastly, in terms of alignment, you look at the overall mission and intent of Congress in the program, and it is to stimulate the economy in general in the small business segment.

When you have a fund-to-funds, and you have the flow of the funding to give rise to the creation of new small business asset management firms, who in turn are then supporting investment in small businesses, you go from having an SBIC licensed entity that perhaps in the more traditional programs would be investing in 20 to 30 small businesses.

You then multiply that by 10 to 20, based on the number of fund managers, and all of a sudden you're talking about 200 to 600 small businesses or startups getting funding as a result of one license.

And not only that, but we're also creating the networks, the technical assistance and support for more funds to potentially become SBICs, or to help them more broadly become successful. And through a safe harbor we've given on conflicts of interest or value driving investments, and the value driving portfolio companies and the underlying managers, who also facilitated creating strong networks for those underlying fund managers to be supportive of getting their portfolio companies follow-on financing, which we know can be a big challenge.

We're exceptionally excited. The caliber of the applications is really fantastic and we're looking forward to seeing what happens over the long run. Fund-to-funds take a while, so I'm sure we'll be watching for many years to come.

MS. DUIGNAN MINNIHAN: Great. Thank you so much. Kate, Bailey, really really appreciate the detail as well as digging into all of these questions. And with that, very excited to welcome Steve Glover to participate in the conversation.

Steve is Administrative Partner and Chief Financial Offers at Pelion Venture Partners in Salt Lake City, and his firm was the first recipient of the SBIC Accrual Debenture License.

Steve, thank you for joining us.

MR. GLOVER: Thanks. It's great to be here. Thanks for the invitation. As you mentioned, we're the first licensee for this new program. On the panel we have Bailey, representing the SBA, the Agency, regulator Kate, who is an important facilitator who understands the regulation and can help licensees and then a licensee. And Kate and Bailey did a great job outlining.

I'm going to give you sort of the licensee or the user perspective this program. Pelion, as Erica mentioned, we're headquartered in Salt Lake City. The firm's been around for over 30 years. Our first SBIC license dates back to Fund 3 when we were manager in 2002. This last license is our fifth SBIC. As Kate and Bailey mentioned, three of our licenses were un-leveraged and we went through the process to apply for our bank LPs.

Maybe something that is somewhat unique about Pelion is we'll raise a fund and one of our parallel funds within our fund family will be an SBIC. The last few funds, that's been relatively small, maybe 20, 25 percent of the fund is raise -- of the family of funds is raised through the SBIC.

Let me just give you a little bit of background on Pelion. We are early stage software investors. Primarily our dollars go to Series A, but we also investor in C, sometimes pre-revenue, sometimes just an idea, also in a series B. But primarily that series A, meaning that the company's very early, has some revenue, some tracks and some product market fit, we'll typically try to own 10 to 15 percent in equity and we'll take a board seat. And part of the advantage of having an experienced manager invest is we've seen the movie of a startup many many times over many cycles, business cycles, so we can help a small business navigate difficulties, help them build a team and scale.

When we mentioned Utah, I think about 30 years ago the partners would have to say, yes, we're in Utah, but we invest on the coasts.

What's happened in Utah over the last couple decades is we've seen waves of technology. So

I'll mention some companies that some of you might remember, like Novel, Word Perfect, iOmega, back in the early wave, back in the seventies to nineties, and then Vivid, Lucid, Ancestry, Overstock. What happens is these waves of technology spin out new entrepreneurs who say, I was with the startup, I want to start something.

So as we see these waves, we see increase in an ecosystem of startups. And the advantage again of having venture capital is to allow them to scale a business and to have the capital to hire and to grow. We see job growth in Utah and this ecosystem being very strong.

So now when we go out and raise funds from investors, we say about, the story of Utah, we invest about 50 percent of our capital in local businesses in Utah, the rest, as Bailey and Kate mentioned, U.S. small businesses. So why would we again go get licenses?

Even though they were unleveraged, we have bank LPs that have been with us for multiple funds. Our Fund 6 raised so quickly we didn't have time to get the license. And so the banks didn't come into the fund. And then they encouraged us to get together and get our license with the SBA. As we were introduced to this program -- look, I'm a former accounting professor, the term accrual debenture was a little scary to me. And our first reaction was, you know what, we're doing great with these unlevered licenses. I'm not sure we want to think about it.

Fortunately for us, Bailey sat down and explained the program. So Kate and Bailey properly said the SBA is not an LP. But from a practical purpose, from a manager's standpoint, they're our largest LP in the sense that they'll represent our SBIC at this time will be about 40 percent of our total dollars raised and the SBA of that 40 is over, so more than 20 percent comes from the leverage.

We think of, they're our regulator, but the way we manage those dollars is the way we would manage in LP dollars. When we call capital, we'll go access the leverage and we'll pull that down. I'll use the word clever, and we don't always think of regulation and government programs as clever.

This is a very clever program, because the SBA is able to get dollars into small businesses through expert managers and you heard, but I'll say it again, no appropriated dollars. The SBA can use this federal loan guarantee, go out and raise private capital, use that to get to a VC manager. We heard from Marcia that right now the demand exceeds supply.

Our demand has grown in dollars that we can invest because of the Accrual Debenture Program. It's critical that that program doesn't require us to service the debt initially, because that's just not the way early stage investing works. We invest, and it could be 5, 6, 7, 8, 9 10 years, before our company is in a position to exit. As that exit occurs, as Kate and Bailey said, we'll take care of the interest and pro rata pay you back the leverage in our investors.

So very clever in getting it to small businesses. And you heard that we do have some restrictions on what we invest in, but for us as early-stage software investors, we don't run into many restrictions. I'll give you an example, in the prior fund out of say 40 investments, one or two may not have gone into our parallel SBIC that went into a main fund. It's typically because we might have invested in a later-stage company or a round of investing included secondary investments. It wasn't initial dollars. But we don't have a lot of restriction on what we're investing in because of the SBIC.

We talked about it. So it's interesting.

When we use the phrase, hey, we've got an accrual debenture or leverage program, initially some LPs say, yeah, we're not interested, we can't do that. The banks get it very quickly. And then they understand the benefit of having the leverage which is capped at the interest rate. And the upside that goes to them. We have some LPs that when they get it they say, I was going to invest in the main fund, could I shift to an SBIC and that is an option.

Interestingly, some of our largest anchor LPs, they might be pensions or things, they still that term causes them a little bit of consternation. They stay in the main fund and say, everything is great with the main fund, we like what you do, we're going to stay there. But it's been interesting having those conversations.

Just again as a history, early on our first SBIC, the fund was an SBIC fund. And it was a leveraged fund under a prior program. Then we had three licenses with three different funds that were not levered. And over time the SBIC was a smaller slice of the, our family of funds. With this latest fund because of the leverage, again, the SBIC parallel fund will be 40 percent of our total funds invested.

Let me see if -- like I said primarily Series A. We'll invest in Utah, Southern California and then The Coast. And we have portfolio companies in St. Louis and Boston and Austin, but there are a good number in Utah because of the exciting things that are happening in the ecosystem here. Primarily software is what we're looking at.

So with that, from a user perspective, like I said, we don't always think of the word clever with programs like this. Super clever. As a taxpayer, to hear that Bailey's program doesn't cost us any appropriated dollars. At first it sounded too good to be true, but it works, and it has worked for decades and billions of dollars being put in because of the federal loan guarantee. And for us to be able to go through a process. I would be happy to answer questions about what the licensing process was like, what the regulatory and examination process is like.

I will tell you one of our big LPs that sits on our advisory, our LPAC, gave a little speech at our last LPAC meeting and they said to the other investors outside the SBIC, you're welcome. What are you talking about? Your managers are getting more due diligence, more oversight and more examination because they have an SBIC license and all of you are benefiting from that additional oversight. Which was a nice way for them to sort of frame congratulations, that you have a manager that's getting oversight from the SBA program.

So with that, happy to answer questions. And by the way, Bailey or Kate, if there's something you need to clarify about what I said, feel free.

MS. DUIGNAN MINNIHAN: Thank you, Steve. Really appreciate your perspective.

I would love to start with a question, which is that we had actually looked at the SBIC Accrual Debenture Program last year, and I did run it by some of our larger institutional investors who seemed a little apprehensive around the idea.

So can you tell us a little about any objections you might have gotten from LPs and how you were able to overcome them and explain to them why this program is different and more suited for a venture capital firm.

MR. GLOVER: Yeah, Erica. So frankly we do a bit of translation. We say, here is the program and then we translate it to the way it practically hits us and other LPs. The other LPs are concerned about what are the restriction and what's the priority or the preference.

When we explain that it's matching capital, doesn't restrict our investment or investment thesis. And when they finally get their head around, let me get this straight, the SBA is going to put in money. Then once you pay them off and you pay off the interest and all of that, any upside goes to the equity investors. And I'll give you some simple approximate numbers. If we're able to 2X a fund and our goal is a 3X a fund. Remember the 2X a funds, the DPI that goes to the equity investors after the SBA is paid off goes to 2.7.

If we're able to 3X a fund, payoff the SBA, the equity investors could get a DPI of 4.5. So when they finally -- sorry, Bailey, the accrual debenture term, once they get past that and they say, what is this in practical terms. It's like equity that comes in with a capped return of interest. And we don't have to service the debt. So we don't have to do unnatural things.

We'll follow our pattern of distribution. When there's an exit, we'll distribute. And yes, interest is on the top of the stack. They get that, right. But then it's pro rata from that point forward. So what we've had to do is sort of translate. You can think about it as a great equity investor that kind of just wants return of interest. And if we do our job, and now we have a track record and multiple funds, they can have confidence that we'll do our job and pay back the SBA and have upside returns. That said, even with all that translation we've had some that say, thanks you very much we're happy to stay in your main fund.

MS. DUIGNAN MINNIHAN: Thank you, Steve, that's helpful. More questions from the committee? Great, Stacey, take the floor.

MS. BOWERS: I'll ask another question. So I'm curious, and I'm not sure, this could be for any of the three of you, but for not, maybe Steve, for a non-bank LP, what makes this attractive?

MR. GLOVER: For the non-bank LPs they do ask, might there be restrictions on what's invested and we'll say, yes, our history is occasionally there's an investment that doesn't qualify as a small business and that parallel fund, the SBIC, won't invest, but it's relatively, it's just a small component.

Then they get this upside. So when I translate the leverages as leveraged return. So the SBIC is clever. They get money into small businesses. We repay them, they re-deploy into the next small businesses and so forth and what it will do is attract top equity investors to say, you know, Kate talked about the history of sort of performance of SBICs, this allows them once the SB is paid back to have the upside. So the investors who have done the math come up to us and say, is it okay if I transfer, I was sitting on the main fund, but I would like to transfer to the SBIC.

Right now the vast majority of the LPs in our SBIC are banks for the reasons that Bailey and Kate, and that's why we've gone to get the license for our bank LPs, which is also clever because they want to reinvest in communities and they get this Community Reinvestment Act credit. The ones that want to switch have just done the math, frankly.

MS. PRICE: So I would just layer into that. So the potential for improved returns I think drives a lot of non-bank investors to SBICs. And particularly tight fundraising markets, like the one we're in now, you get increased diversification in the fund. So if a fund wanted had initially wanted to go out and raise 100 million, but due to the current fundraising markets can only raise 50, if you go to the SBA and get leverage, you're now back to the diversification that you initially had intended.

You're back to the check sizes that you had originally intended. So we see do see in particular in these tight credit markets, right, the LPs are getting the security of optimally-sized funds and the diversification that comes from that.

MS. DEVRIES: I'll just add a couple more things. Oftentimes we'll hear that non-bank investors value the increased oversight from the SBA, knowing they have gone through our due diligence process, all of our screening, all of our checks, as well as transparency from a reporting perspectives. We have data that is disclosed to us on a quarterly basis, but then any LP in the fund can also ask to receive whatever the SBIC receives. And then downside protection that can be an effect of the leverage, as well.

The last thing I'll share, and it's not the interest rates today, but funds, if they do have any liquidity, partial liquidity events, full liquidity events, they have the ability to recycle our capital. So you can choose not to make distributions and to recycle. If we look back, I'll take our debenture poolings from September of 2021 and March of 2022, our interest rate in September of 2021 was 1.3 percent. In March of 2022 it was 2.9 percent. Those are the interest rates on the debentures.

So we have funds that have capital from us with interest rates incredibly low compared to current market interest rates and they're able to service interest payments on that if they had distributions or they don't have to in the case of the accrual. And then recycle capital at below market interest rate for up to 10 years. So that is an incredible advantage when you might think of some other funds in private credit and buyout that are getting leverage from banks at a much higher interest rate today. So massive spread opportunity there.

MS. DUIGNAN MINNIHAN: One quick question, this is a wonderful program and so excited about it, but let's say, you know, you are raising $100 million fund, you have 50 million, let's say you're using one times leverage. Is there sort of a point at which you're no longer eligible, and let's say even if you're on Fund 5 or something, do you have to figure out how to replace those LPs, does it phase out or can you sort of continue in the program indefinitely?

MS. DEVRIES: You can continue in the program indefinitely. At the end of the day, our goal is to have strong partners that are aligned to our mission. And if they remain aligned in terms of goals and objectives, are a good steward of the program, compliant with regulations, continuing to make a big impact in terms of getting financing to small businesses and contributing to economic growth and jobs, those are the funds we want in the program.

The program has continued to grow in terms of commitments. We have great capacity to add new managers today, continue not to have issues when we identify a need for higher commitment ceiling, there's no appropriation associated with it. So I do not foresee any restrictions being put on. I don't think that that that would be in the best interest of the program over the long haul.

MS. PRICE: I would just add to that, I think one of the interesting things about the program but that's also very positive, is a number of funds because they don't want to outgrow the leverage ratio, right, the larger the fund gets the less impact that benefit can become because it becomes marginally less dollars. And so you do see a lot of fund managers intentionally keeping their funds static sizes.

Again, kind of stepping back and looking at some of the gaps in the market, the trend in non-SBIC funds is to get larger and larger and that leaves small businesses particularly underserved. I think one of the benefits of this program is you see fund managers that are very much committed to low or middle market. They're not growing their fund sizes. They are on Fund 6 and they are still raising funds that are approximately the same size as they did on Funds 3, 2, 1. And so I think in terms of capital access for those small businesses it's a wonderful mechanism because you have a lot of fund managers that intentionally stay here. And you get the value of them and their experience, having been here for decades.

MS. DUIGNAN MINNIHAN: Great. Herbert has a question.

MR. DRAYTON III: Yes, a question for the group. Based on the applications you're receiving thus far, is the program reaching qualified emerging fund managers or is there still an information gap?

MS. DEVRIES: Yes. We are reaching a number of qualified emerging managers. I'm excited to say, there's a number of individuals that are spinning out of firms to go launch their own funds that we see in the applicant pool today. That's excellent. That gives rise to the creation of new asset management firms that are small businesses and diversified GPs that are allocating capital, which is excellent. I do expect that the re-investor SBIC licenses, based on the application that's have been put forward with a focus on emerging manager will further increase access to capital for small and emerging managers.

That said, we do receive prescreens that might come from individuals who they have never had an exit before. Or they have not made investments before, and maybe don't have another principle on the fund who had. So those wouldn't be eligible teams, because when you think about taxpayer dollars at risk, are giving well over $100 million to an individual that has never made private investments before, it's not the intent of the program.

Our goal is to increase education and awareness and different pathways for those individual who would like to be supportive of the mission to think about how do they approach getting there. Our goal is to have more small business asset management firms and to get more capital to small businesses, so we want to be supportive however we can. Which is why we have different pathways and innovative structures and why we do the prescreen form free of charge. So that way we can get feedback and there's not a financial burden for those interested in pursuing it.

MS. DUIGNAN MINNIHAN: Great. Looks like we have a question from Bart.

MR. DILLASHAW: Yeah. Do you have any data on sort of the range or size of funds, sort of at the low end, with the minimum size and maybe a median number.

MS. DEVRIES: I can say historically -- so actually I'll lead with, it will look different 12 months from today as we work through the new pipeline of applications that are using the more diverse array of instruments we have with the accrual instrument and the standard debenture instrument and the different license types with the Fund-to-Funds, the accrual and the standard.

Historically the majority of funds would have about 86, 87 million in private capital and they would be going for two times leverage on that since the cap was 175 million. So standard would be SBA capital puts private capital around 260, 262 million overall would be the fund size. I said that was kind of the most common of what you would see.

That said, the minimum threshold is very low. It is actually $5 million. The question then becomes around portfolio construction, can you get enough diversification, can you have enough in reserves particularly if you're doing equity, to be able to layer your winners, you have to cut out your losers. So the size of the fund has to match with the check size and the investment strategy and portfolio construction that's being proposed. But we do have funds in the program that are very small and some of the non-levered funds, right, where we don't have the issue of credit underwriting and putting the federal credit reform taxpayer dollars at risk, from that sense, there are funds that are 25 million, 30 million and getting their start that way.

MS. PRICE: I would just layer on top after that, I do think as Bailey mentioned, we'll see smaller funds and increasing numbers with these new strategies, because historically the funds that we've seen on the smaller end have been those unleveraged funds because they have venture and early stage strategies that made them ineligible for leverage. So I think in particular, I can think of a new funds that have very focused investment strategies on the earlier stage but in particular geographies for example that are underserved. And they're really looking at the markets that they find themselves in and identify what is the need and creating an investment fund for that. So there are funds as small as 10 million, but they're really targeting this gap in their local markets, the regional markets. So I do think you'll see more of that.

One thing I don't think we touched on but in addition to SBICs getting capital in greater numbers to diverse-owned businesses and LMI areas. You also see more geographic diversity within SBIC funds. And I do think that's important to add. You have certainly some funds licensed in what you consider your traditional capital markets, but you have a lot of SBIC funds throughout the country that have networks in the areas of the country where they're at. I think that's sort of plugging the gap in the markets where you have less access to capital or having funds located in those traditionally underserved markets.

And I'll also throw a plug in, that for those funds they are priority for the SBA. So those funds in terms of their license application kind of get to go through the front of the line and processed more quickly because it is a stated priority of the Administration to get more funds licensed in those underserved geographies.

MS. DUIGNAN MINNIHAN: Thank you, Kate. So not sure if we have any more questions from the committee. Would love Bailey to just answer one quick closing question, which is, Kate just spoke about the stated priorities of the program. Are there any other stated priorities of the program we should be aware of.

MS. DEVRIES: Yeah. So the one that is the top priority, which is legislated is underlicensed states. And we publish that data on our website regarding which states are underlicensed. Those go to top priority at the end of each filing window. From there, we have underserved and undercapitalized broadly, which includes rural, low income areas. And then for the fund to explain in the business narrative, what is the underserved focus that they are solving for, what is the undercapitalized need that they're solving for. We do go into a little more detail in the undercapitalized to talk about the industrial transformation as well as national security. So as Kate pointed out, it's not about things necessarily that Department of Defense or three letter agencies would buy, but it is about having capabilities, technologies, components here in the U.S. And we reference back to the statute here around the need for the supply chain to be resilient here in the U.S. and manufacturing to be supported through the program.

So those are our top priority areas. And they're not in rank order. They are all priorities. That said, if you come to us and you're aligned to our mission and you are not focused on those priority areas, but you are focused on our priority overall of financing the small business segment of the U.S. economy, and meet all the other eligibility criteria, by all means, we want great partners that are helping the mission of financing small businesses.

MS. DUIGNAN MINNIHAN: Wonderful. Thank you so much Bailey. To wrap up I would love to ask both Steve and Kate, what's your top piece of advice for a fund that might be pursuing an SBIC license?

MS. BOWERS: Steve, go ahead.

MR. GLOVER: It's very helpful to plug into a network and talk to those who have already been licensed. It's very helpful to have some expertise like Kate. The regulations, while you can read them, there's a lot there, so plug it into a network to say, how did this happen. Let me just make two other comments that Bailey just talked about. Like in the State of Utah, we love Utah.

Most of the invested capital comes from outside the State. But a startup entrepreneur would prefer their manger, board member to be local. We incubate some of the companies right in our office and the interaction that happens with local managers and new founders and first time entrepreneurs is very important.

And then I'll say, Erica, one other question I thought of that people ask, are you restrictive in SBIC to only invest in small businesses as defined. In other words, can you follow on if you have something that's scaling.

And the answer is yes. That's critical because in a venture fund some companies just won't come out the other end. We try to help that entrepreneur have soft landing. But those that do take off where the returns come from.

So the program allows us while it needs to be a small business for those initial checks, we can follow on in their later series as long as we stay within our concentration limits.

Thank you. It's been a pleasure.

MS. PRICE: Yeah, I would actually just say, Steve went to the same place that I did.

Which is there is actually a phenomenal

community within SBICs, both other fund managers and people knowledgeable. They have a trade association that's very active. There is a group of fairly generous of spirit people. So if you're interested I would say tap into that resource base, because it is a complex process. And kind of tied to that, I would say start early. I am particularly passionate about working with some emerging managers in that set.

To Bailey's point, even if an SBIC fund isn't something that is in the cards right now if you really are just starting out, you know, thinking intentionally about your firm and your direction and starting to talk to people now so that the firm that you're building is eligible in your next fund perhaps for an SBIC. So I'd say talk to people and then start early and be intentional about what you're building.

MS. DUIGNAN MINNIHAN: Great. Thank you so much, Kate, Steve and Bailey. As usual, it has been a wonderful discussion and we really appreciate your time and valuable insights today.

MR. GLOVER: Thank you.

MS. DUIGNAN MINNIHAN: Wonderful.

I would love to thank the Committee, the speakers and everyone who joined us virtually as well as the Commissioners and the Chair for a wonderful discussion. Our next and final meeting for 2024 is scheduled for November 13th.

We also want to give everyone visibility into upcoming meetings so you can mark your calendars. We've selected the following dates for the Committee's quarterly meetings in 2025. They will be February 25th, 2025, May 6th, 2025, July 22nd, 2025 and November 4th, 2025. Please mark your calendars. And with that, I hereby move to adjourn the meeting.

MR. DRAYTON III: Second.

MS. DUIGNAN MINNIHAN: All in favor.

MR. DRAYTON III: Erica, what was that February meeting again?

MS. DUIGNAN MINNIHAN: February 25th, 2025.

Wonderful. And with that our meeting is adjourned. Thank you everyone and have a wonderful rest of your day.

(Whereupon, at 12:47 p.m., the meeting was adjourned.)

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PROOFREADER'S CERTIFICATE

In The Matter of: SMALL BUSINESS CAPITAL FORMATION ADVISORY COMMITTEE MEETING

File Number: OS-0001

Date: Tuesday, July 30, 2024

Location: Washington, D.C.

This is to certify that I, Kyleigh McGinnis, (the undersigned), do hereby swear and affirm that the attached proceedings before the U.S. Securities and Exchange Commission were held according to the record and that this is the original, complete, true and accurate transcript that has been compared to the reporting or recording accomplished at the hearing.

_______________________ 8/6/2024

Kyleigh McGinnis (Date)

CERTIFICATE OF REPORTER

I, DEBRA GOODFRIEND, a Certified Shorthand Reporter and Notary Public of the State of New York, certify that the foregoing is a true and accurate transcript of the stenographic notes of the deposition of said witness who was first duly sworn by me, on the date and place hereinbefore set forth.

I FURTHER CERTIFY that I am neither attorney, nor counsel for, nor related to or employed by, any of the parties to the action in which the deposition was taken, and further that I am not a relative or employee of any attorney or counsel in this case, nor am I financially interested in this case.

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