

SBIC TechNote 7b: Guidelines Concerning Allowable Management Expenses for Leveraged SBICs

Applicability: This TechNote applies to all SBICs licensed on or after April 1, 2004 that have or intend to seek SBA leverage. This TechNote supersedes TechNote 7a (April 2008) and is effective January 1, 2018. To the extent that an SBIC's limited partnership agreement or similar governance document approved by SBA prior to the effective date of TechNote 7b *expressly* permits payment of management expenses inconsistent with the policies identified in TechNote 7b, the terms of the SBIC's governance document will control.¹

A. Introduction

SBA must approve management expenses for leveraged SBICs as required by SBA regulations §107.140 and §107.520. The purpose of this TechNote is to clarify 1) the conditions under which SBA would approve management expenses and 2) clarify regulations, policies, and reporting related to such expenses. This includes clarifying what is considered a management expense or paid out of the management fee, outsourcing management expense activities, SBA's position on management fee offsets and waivers, and disclosures. This TechNote is intended to provide general guidance only; an SBIC should resolve specific situations with its financial analyst in the Office of SBIC Operations.

SBA recognizes the critical role that an SBIC's management team plays in a fund's performance. In licensing new SBICs, SBA places great emphasis on establishing that the proposed management team is qualified. SBA also recognizes the importance of SBICs providing adequate compensation to the members of the management team and having adequate revenue to pay for all other management expenses, if permitted to be paid under SBA regulations. However, SBA also has a statutory obligation to ensure that SBICs utilizing government-guaranteed leverage are financially sound and that the government's financial interests are protected. SBIC expenses are an important consideration in this regard since management expenses are typically the largest SBIC expense.

These guidelines are for determining the maximum management expenses permitted by SBA. SBA recognizes that management expenses are an important business issue negotiated between fund managers and investors and that investors may wish to negotiate a lower fee. SBA generally looks favorably on lower management fees, but may decline to approve an alternative fee structure that is excessively complex or lacking in transparency.

B. References and Definitions

1. Related References

[§107.140](#) - SBA approval of initial Management Expenses.

[§107.520](#) - Management Expenses of a Licensee.

¹ Actions taken prior to the effective date of this TechNote are governed by the regulations and policies in effect at the time such action occurred. Nothing in this TechNote bars SBA enforcement action with respect to any action taken prior to the effective date of this TechNote in violation of regulations and policies in effect at the time of such action.

[§107.585](#) – Voluntary decrease in Licensee’s Regulatory Capital.

[§107.855](#) - Interest rate ceiling and limitations on fees charged to Small Businesses (“Cost of Money”).

[§107.860](#) - Financing fees and expense reimbursements a Licensee may receive from a Small Business.

[§107.900](#) – Management fees for services provided to a Small Business by Licensee or its Associate.

SBA Model Limited Partnership Agreement (Model LPA):²

[Version 2.0, SBA Model Form Of Agreement Of Limited Partnership For an SBIC Issuing Debentures Only, October 21, 2010](#)

[Version 3.0, SBA Model Form of Limited Partnership Agreement For an SBIC Issuing Debentures, March 26, 2016 \(must be used for all applications submitted on or after October 1, 2016\)](#)

2. Definitions

a. Investment Adviser/Manager

§107.50 defines “Investment Adviser/Manager” as “any Person who furnishes advice or assistance with respect to operations of a Licensee under a written contract executed in accordance with the provisions of [§107.510](#).”

b. Management Expenses

§107.520(a) defines “Management Expenses” to include the following: “(1) Salaries; (2) Office expenses; (3) Travel; (4) Business development; (5) Office and equipment rental; (6) Bookkeeping; and (7) Expenses related to developing, investigating and monitoring investments.”

Pursuant to §107.520(b), “Management Expenses do not include services provided by specialized outside consultants, outside lawyers and independent public accountants, if they perform services not generally performed by a venture capital company.” In general, SBA considers all expenses related to the routine operations of the SBIC to be Management Expenses.

Per §107.140, for any SBIC that plans to obtain SBA leverage, the SBIC must obtain SBA’s approval of its Management Expenses at the time of licensing. This approval is typically obtained through SBA’s approval of an SBIC’s Limited Partnership Agreement (LPA). In addition to the initial approval under §107.140, SBA must approve any increases in Management Expenses for SBICs with outstanding leverage (see §107.520).

SBA’s Model LPA sets forth standardized language addressing the calculation and payment of Management Compensation (used interchangeably with “Management Fee” in this TechNote) offsets of certain financing fees and management fees an SBIC charges to a portfolio company, as well as the expenses that SBA considers to be management expenses or partnership expenses. SBA encourages SBIC applicants to follow the language set forth in the Model LPA to the maximum extent possible.

² The vast majority of SBICs are organized as limited partnerships. Accordingly, this TechNote describes management expenses for SBICs in terms relevant to that organizational form. The policies described in this TechNote apply to all SBICs licensed after its effective date regardless of organizational form.

Most SBICs pay a Management Fee to the General Partner (GP) or, more typically, the Investment Adviser/Manager which in turn pays all Management Expenses. Model LPA Section 3.05 allows an SBIC applicant to insert a formula for the calculation of the Management Fee. SBA will generally not approve a Management Fee that exceeds the [Maximum SBIC Management Fee](#), as defined in this TechNote.

Model LPA Section 3.07(a) requires that the entity receiving the Management Fee must pay all Management Expenses. Model LPA Section 3.07(b) identifies all authorized partnership expenses, including the Management Fee paid to the GP or Investment Adviser/Manager. Any expenses not expressly authorized under Model LPA Section 3.07(b) must be paid by the entity receiving the Management Fee.

Although the Model LPA sets forth the expenses paid by the GP or Investment Adviser/Manager out of the Management Fee and those paid out of the partnership, the table on the following page is meant to provide further clarification:

- ***Column A – Covered by Management Fee*** provides examples of expenses SBA considers to be Management Expenses and which *must* be paid out of the Management Fee. These are the type of expenses identified in Model LPA Section 3.07(a).³
- ***Column B – Not Required by SBA to be Covered by Management Fee*** provides examples of expenses SBA does not consider to be Management Expenses and which are not required to be paid out of the Management Fee. These are the type of expenses identified in Model LPA Section 3.07(b).⁴

³ Section C of this TechNote describes the limited circumstances in which SBA will permit an SBIC to pay for a Management Expense as a partnership expense, offsets that must be applied against the Management Fee, and other guidance relevant to compliance with SBA's Management Expense regulations.

⁴ SBA would likely approve any LPA in which these expenses were paid by the Investment Adviser/Manager out of the Management Fee and included in LPA Section 3.07(a), but SBA does not require these expenses to be covered by the Management Fee.

Table 1 - Examples of Partnership Expenses Covered and Not Required to be Covered by the Management Fee	
Column A - Covered by Management Fee	Column B - Not Required by SBA to be Covered by Management Fee
<ul style="list-style-type: none"> • Compensation of employees of the SBIC, general partner and the Investment Adviser/Manager, including salaries and fringe benefits. (SBA will consider distributions to personnel from the Investment Adviser/Manager to be part of compensation.) • Office related expenses including rent, equipment, supplies, postage, communications (e.g., telephone, facsimile, and internet). • Dues and subscriptions not in Column B. • Business development (e.g., pitch meetings or private equity industry conferences). • Bookkeeping and similar activities such as accounting and financial reporting (for limited partners or SBA), including preparation of annual and interim financial statements of the SBIC, portfolio financing reports, and capital certificates. • All activities related to development, investigation, and monitoring of investments.⁵ This includes without limitation finder's fees, underwriting activities, review of a prospective portfolio company's financial statements, background investigations of key individuals, quality of earnings reports, review of purchase/credit agreements, and investment memorandums. • Travel (including travel related to development, investigation, sourcing, executing, or monitoring investments). • Activities related to preparation for SBA examinations and audits. • Support and general services to the SBIC. 	<ul style="list-style-type: none"> • Audit of SBIC financial statements. • Legal services provided by outside counsel. • Preparation of Federal, state and local tax returns. • Specialized consulting services related to an industry or technology, such as environmental consulting. • SBA fees, including SBA licensing fees, examination fees and Debenture fees. • Taxes payable by the SBIC to Federal, state, local, and other government agencies. • Expenses incurred with the actual or proposed acquisition or disposition of assets, such as accounting fees, brokerage fees, legal fees, and registration. • Insurance and premiums protecting the SBIC, the General Partner, the Investment Adviser/Manager, and any of their officers, directors, managers, owners, and employees. • Reasonable costs and expenses associated with limited partner and advisory board meetings. • Organizational expenses, to the extent permitted in the SBIC's organizational documents and deemed reasonable by SBA (presently, the lesser of \$500,000 or 2% of Regulatory Capital). • Fees and dues in connection with the membership of the SBIC in any trade association primarily representing the interests of SBICs.

⁵ SBA considers these activities and expenses to be Management Expenses, regardless of whether a letter of intent, term sheet, or similar document expressing interest in an investment has been signed.

c. Maximum SBIC Management Fee

The Maximum SBIC Management Fee allowed by the SBA is determined in accordance with the following formula:

$$\text{Maximum SBIC Management Fee} = \text{Management Fee Base} \times \text{Management Fee Rate}$$

The [Management Fee Base](#) varies based on whether the SBIC is in its [Management Fee Initial Period](#) and the [Management Fee Rate](#) varies from 2% to 2.5%, depending on the size of the Management Fee Base. These terms are defined in paragraphs 2d, 2e, and 2f of this section.

The Maximum SBIC Management Fee formula assumes a stand-alone licensee that bears all of the expenses of its operations. In determining whether to approve an SBIC's proposed Management Fee, SBA will take into account other relevant factors, including whether the Investment Adviser/Manager is advising more than one investment fund. Based on those factors, SBA may determine in certain cases that a lower maximum allowable Management Fee may be appropriate.

This calculation is meant to identify a maximum allowable Management Fee. As noted above, an SBIC may propose a fee or formula in its LPA that results in a lower fee. Examples of generally acceptable alternate structures include:

- Using "Outstanding Leverage" instead of "Assumed Leverage" in the definition of Management Fee Base during the Management Fee Initial Period;
- Setting a lower Management Fee Rate than the maximum permitted;
- Decreasing the Management Fee Rate after the Management Fee Initial Period; or
- Decreasing the Management Fee Rate upon a specified event, such as an SBIC exceeding its maximum capital impairment percentage or the manager of the SBIC forming a new fund.

If an SBIC chooses to use an alternative formula for calculation of the Management Fee, it must include in its LPA the following statement: "The Partnership will not pay any Management Compensation with respect to any fiscal quarter in excess of the Maximum SBIC Management Fee payable under the formula set forth in SBA TechNote 7b."

d. Management Fee Initial Period

SBICs typically have a five-year active investment period during which the SBIC is permitted to make new investments. Management Fees should decrease after an SBIC's investment period has ended, since the managers are no longer spending time sourcing, negotiating or underwriting new investments. Note that although certain types of SBICs may have longer investment periods, such as SBICs that are BDC subsidiaries, these SBICs must also use a formula that results in lower Management Fees during the later years of the SBIC's lifecycle.

In computing the [Maximum SBIC Management Fee](#), an SBIC's "Management Fee Initial Period" (which typically coincides with an SBIC's five-year investment period) commences on the earliest of the following:

- 1) Date of SBIC license approval;
- 2) Date on which the SBIC or the applicant acquires its first portfolio securities;
- 3) First date any Management Fee based on assumed leverage begins to accrue or is paid (whichever is earlier).

The Management Fee Initial Period ends on the date five (5) years from the start of the Management Fee Initial Period, or any earlier date specified in the SBIC's LPA. (*Note: SBA generally will not approve an extension of the Management Fee Initial Period even if SBA approves an extension of the investment period.)

e. Management Fee Base

1) During the [Management Fee Initial Period](#),

$$\text{Management Fee Base} = \frac{\text{Management Fee Unreduced Regulatory Capital}}{\text{Assumed Leverage}}$$

i. **Management Fee Unreduced Regulatory Capital** is defined as the sum of:

- Regulatory Capital at the time the fee is paid or begins to accrue (whichever is earlier).
- Any Distributions previously made under §107.585 which reduced Regulatory Capital by no more than two percent or which SBA approves for inclusion in the Management Fee calculation. (Note that this approval is separate from the SBA approval required for the distribution itself; in other words, SBA can approve a distribution under §107.585, but disapprove the inclusion of the distribution amount in Unreduced Regulatory Capital).

The effect of increases in Management Fee Unreduced Regulatory Capital on Management Fees must be recognized no earlier than the first day of the fiscal quarter in which the SBIC notifies SBA of the increase as evidenced by an executed Capital Certificate (i.e., the submission date of the Capital Certificate, not the date of the Capital Certificate). Such increases cannot be applied retroactively to previous quarters. The effect of decreases in Management Fee Unreduced Regulatory Capital must be recognized as of the first day of the fiscal quarter in which the decrease occurs.

- ii. **Assumed Leverage** means the maximum amount of SBA-guaranteed Leverage that the SBIC may apply for consistent with the SBIC's business plan approved by SBA. This amount may not exceed two (2) times the SBIC's Regulatory Capital. In addition, an SBIC that receives SBA approval for Leverage commitment greater than two times Regulatory Capital under 13 CFR §107.1150(a) may add that additional amount to its Management Fee Base.

2) After the [Management Fee Initial Period](#),

Management Fee Base = Cost of loans and investments for all "active" portfolio companies, not to exceed the highest Management Fee Base during the Management Fee Initial Period

An "active" portfolio company is defined as a company that remains an ongoing concern and in which the SBIC's investment has not been written off or written down to zero. Loans and investments valued at zero are considered written off for the purposes of calculating the Management Fee. The "active" status of a portfolio company is subject to SBA's review. In determining whether to write-down or write-off an investment, the SBIC must adhere to the Valuation Guidelines for Small Business Investment Companies which state, "[w]hen a

decline in Asset Value appears permanent, a complete or partial write-off of the asset (i.e., recording a realized loss rather than unrealized depreciation) should occur.”

The cost of loans and investments used in this calculation will be the cost as of the first day of the fiscal quarter for which the fee is paid or begins to accrue (whichever is earlier) minus any noncash capitalized interest, such as Payments In Kind (PIK), as reported on the Form 468. (Capitalized interest should not be included in the cost of loans and investments since this does not reflect the SBIC’s original cost.) If SBA determines the cost of assets to be overstated, SBA may require the portion of the Management Fee related to the overstatement to be repaid to the SBIC.

f. Management Fee Rate

The Management Fee Rate varies between 2% and 2.5%, depending on the [Management Fee Base](#) as shown in the following table:

Table 2 – Management Fee Rate

Management Fee Base	Management Fee Rate
Less than or equal to \$60 million	2.5%
Greater than \$60 million and less than \$120 million	$(2.5\% - (0.5\% \times ((\text{Management Fee Base} - \$60 \text{ million}) / \$60 \text{ million})))$
Greater than or equal to \$120 million	2%

If the SBIC is a drop-down fund, SBA will not approve a Management Fee Rate that exceeds that of its parent.

C. General Management Fee Policy, Procedures and Notes

There are several other considerations in SBA’s approval and review of management expenses/fees that should be noted as described below.

1. **SBA Approval.** Nothing in this TechNote eliminates your obligation to obtain specific SBA approval of your Management Fees as required by Regulations §107.140 and §107.520.
2. **Prepaid Management Fees.** Where Management Fees are being prepaid by the SBIC, the amount may be no more than three months in advance.
3. **Outsourced Management Expense Activities.** SBICs may decide to outsource certain activities considered to be covered by the Management Fee, such as those listed in Column A of Table 1. An SBIC may outsource certain functions as long as the approved General Partner or Investment Advisor/Manager still performs the core functions of managing the SBIC, e.g., sourcing and negotiating deals, performing the bulk of the due diligence, and monitoring the portfolio. ***The General Partner must have sole discretion and bear sole responsibility for making investment decisions.*** Typical examples of outsourced Management Expense activities include bookkeeping, reporting, and accounting.

As a general rule, the cost of such outsourced activities must be paid out of the Management Fee by the SBIC's GP or Investment Advisor/Manager, as shown below:



However, SBA will generally approve an arrangement in which the SBIC pays these expenses as a separate SBIC expense, but only if the aggregate expenses relating to these activities plus the Management Fee (as calculated under the LPA and any applicable side letters) would not exceed the Maximum SBIC Management Fee. Any such arrangement must be clearly described in the SBIC's LPA.

For example, if the Maximum SBIC Management Fee is \$2 million per year, either of the following scenarios would generally be acceptable:

Table 3 – Management Expense Scenarios

Allocation of \$2 Million in Management Fees	Scenario 1	Scenario 2
Management Fee	\$2.0 million	\$1.9 million
Other Partnership Expenses		
- Outsourced Bookkeeping/SBIC Reporting	-	\$0.1 million
Management Expenses/Activities	\$2.0 million	\$2.0 million

4. **Fees Received by SBICs and SBIC Associates.** SBA regulations permit SBICs and Associates of an SBIC (typically the Investment Advisor/Manager, but which may include parallel funds or other entities) to charge certain fees to portfolio companies under §§107.860 and 107.900. SBA believes that any fees received by an SBIC or Associate under these sections must benefit the SBIC. Accordingly, except as provided in this section C.4, any fees charged to a portfolio company by an SBIC or its Associate under these sections must be paid directly to the SBIC or treated as an offset to the Management Fee. Any fees paid into the SBIC must be recorded and reported to SBA as fee income included in Gross Investment Income (not net of management expenses) on SBA Form 468. Any offset required to be applied against Management Fees remaining unapplied as of the liquidation of the SBIC must be paid in cash to the SBIC by the GP or Investment Adviser.

Exceptions:

- a. **Expense Reimbursements.** Expense reimbursements under §107.860(f) may be paid to an SBIC or SBIC Associate (whichever party incurred the expense) with no corresponding offset to the Management Fee, unless otherwise specified in the SBIC's LPA. Note that if an SBIC or its Associate receives expense reimbursements for activities that are considered Management Expenses, such amounts must be included in the Cost of Money calculation defined in §107.855. If SBA determines that any reimbursed expenses are unreasonable or if Cost of Money does not apply (e.g., equity investments), SBA will require you to refund such amounts to the portfolio company to the extent such amounts are unreasonable, exceed the Cost of Money calculation, or the Cost of Money does not apply. See 13 CFR 107.860(f).
- b. **Investment Banking.** The Management Fee offset requirement does not apply to investment banking fees earned and received by an SBIC's Associate under § 107.900(e)(2), provided that the Associate is an entity that (a) is regularly engaged in the business of providing investment banking services, and (b) is a broker-dealer registered with the Securities and Exchange Commission in accordance with section 15(b) of the Securities Exchange Act of

1934. For any Associate that earns and retains investment banking fees pursuant to this exception, the SBIC must maintain in its files, available for SBA's review, evidence of the Associate's status as a registered broker-dealer and documentation of the investment banking services performed and the fees earned.

- c. *Co-Investment.* If any fees that are required to be offset against the Management Fee arise from an investment by the SBIC and an investment by one or more Associates of the SBIC (e.g., a non-SBIC parallel fund) the amount of such fees that must be offset against the Management Fee must be no less than the SBIC's proportion of the investments as identified in the following equation:

$$\text{SBIC Management Fee Offset Minimum} = \text{Amount of Fees} \times \left(\frac{\text{Investment by SBIC/Aggregate}}{\text{Amount of Investments by the SBIC and its Associate(s) in Portfolio Company Paying Fees}} \right)$$

This formula should also be used for the purpose of allocating/offsetting broken-deal fees among an SBIC and any Associate co-investor(s).

5. Use of Management Fees. Management Fees must be used solely to pay for Management Expenses of the SBIC. Management Fees may not be used for unrelated activities such as organizing or managing a second fund. Although not a routine part of SBIC examinations, in circumstances in which SBA believes that an SBIC is not receiving the management services identified in the SBIC's LPA or consistent with the SBIC's representations to SBA during licensing, or in other unusual instances such as allegations of fraud, SBA reserves the right to request that the SBIC provide records or other information from the Investment Adviser/Manager sufficient to allow SBA to determine compliance with SBA's Management Expense regulations and policies.
6. Management Fee Waivers. Some GPs or Investment Advisor/Managers choose to waive a portion of the Management Fee and apply the waived amount to fund a portion of their capital contributions.⁶ SBA requires any party utilizing a Management Fee Waiver to fund at least 50% of its capital contributions to an SBIC in cash. Beginning on the effective date of this TechNote, cumulative capital contributions (i.e., capital contributions from the commencement date of the SBIC) for all SBICs, regardless of whether licensed prior to the TechNote effective date, from GPs, Investment Adviser/Managers or other affiliates must be funded at least 50% in cash.

For example: Assume the GP's commitment is \$5 million and the LPA approved by SBA allows the GP to contribute waived Management Fees for up to 50% of its commitment to satisfy capital calls. If the SBIC calls 20% of private capital at the first capital call, the GP would owe \$1 million, at least \$500,000 of which must be funded in cash. The GP may, however, fund \$1 million in cash at the first capital call and at the next capital call waive the next \$1 million. SBA policy is satisfied if the GP's cumulative capital contribution is at least 50% in cash at any point in time.

7. Disclosures on Form 468.

- a. *Outsourced Services.* SBICs directly paying outsourced service providers must disclose in the notes of the Form 468 the activities performed by each service provider, the associated costs, and whether the provider is performing Management Expense activities and, if so, the portion of the cost associated with such activities. Upon SBA request, SBICs must also provide appropriate documentation to verify what services were provided and the associated cost.

⁶ SBA takes no position on the legality of any such waiver and encourages SBICs to seek the advice of independent legal counsel regarding compliance with applicable tax laws, IRS regulations and policy.

- b. *Management Fee Offsets.* Disclosure of §§107.860 and 107.900 fees has not been consistent among SBICs, making it difficult for SBA to identify such fees, reconcile them against Management Fee offsets, and determine whether all fees have been treated consistently with SBA regulations and policy. It is the SBIC's responsibility to disclose all fees required to be paid to the SBIC or offset against the Management Fee in accordance with paragraph C.4. of this TechNote. For any SBIC that reports Management Fee expense net of offsets on the SBA Form 468, Statement of Operations Realized, the notes to the financial statements must include a disclosure of the total Management Fee expense (calculated in accordance with the SBIC's LPA and any applicable side letters) and the amounts of all offsets for fees received by Associates of the SBIC under §§107.860 and 107.900. In addition, all fees earned by the SBIC or Investment Advisor/Manager under §§107.860 and 107.900 must be appropriately disclosed in the Form 468 under one or more notes to the financial statements (footnotes) for the reporting period in which fees are earned. Appropriate footnotes would include such information as the recipient of such fees (whether SBIC or Associates), type of fees earned, amount of fee earned, total fees earned for the reporting period, and the amount of such fees or part of it, and if any were used to offset management expenses payable to the Investment Adviser/Manager by the SBIC. Upon SBA request, SBICs must make available for SBA's review, all records associated with any fees from portfolio companies of the SBIC that are earned and retained by an Associate.

- c. *Management Fee Waivers.* SBICs must report contributions associated with Management Fee Waivers as "Partnership Interests Issued for Services" in both the Form 468 Statement of Partner's Capital and Part II – Schedule of Regulatory and Leverageable Capital. For any SBIC that utilizes a Management Fee Waiver, the notes to the financial statements must include a disclosure of the total capital committed by the SBIC's GP (or affiliate), the amount of Management Fees waived during the reporting year and cumulatively, and the amount of waived fees that were used to reduce the GP's (or affiliate's) capital commitment during the reporting year and cumulatively.