



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: June 21, 2017

TO: Small Business Investment Companies (SBICs), Applicants, and Interested Parties

FROM: A. Joseph Shepard
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SUBJECT: Draft TechNote 7b – SBA Management Fee Policy

1. **Introduction.** The attached draft TechNote 7b provides an update to [TechNote 7a, Guidelines Concerning Allowable Management Expenses For Leveraged SBICs](#). SBA drafted TechNote 7b to (a) clarify SBA's interpretation of existing regulations and policies relating to management expenses and fees, (b) conform with SBA's current practices with respect to management expenses and fees and (c) update language to be consistent with SBA's new [Model Limited Partnership Agreement \(LPA\)](#), updated in 2016. Per paragraph 4 of this letter, SBA requests comments on the draft TechNote 7b by August 4, 2017.
2. **Background.** SBA 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. SBIC regulations define "Management Expenses" and require that SBA approve each SBIC's Management Expenses. SBA typically approves a fund's Management Expenses through the approval of its LPA. TechNote [7](#) and [7a](#) identified the maximum allowable management fee SBA would approve for SBICs and provided guidance regarding Management Expenses. Currently, most operating SBICs are subject to TechNote 7a.¹ TechNote 7b will supersede TechNote 7a.²
3. **Key Changes.** Key changes in the draft TechNote are discussed below by paragraph.
 - a. **Paragraph B - References and Definitions.**
 - 1) **Related References – (B.1):** This paragraph was added to be consistent with more recent TechNotes and to provide references and links to relevant regulations and documents.
 - 2) **Definitions – (B.2):** This paragraph was added to provide relevant definitions from SBA regulations and consistent with the new Model LPA.
 - 3) **Definition - Management Expenses (B.2.b):** This paragraph sets forth the definition of Management Expenses in the regulations and identifies which expenses must be paid out of the Management Fee,³ consistent with SBA's interpretation of the regulations.

¹ TechNote 7a applies to all leveraged SBICs that submitted license applications on or after April 1, 2004.

² As more fully discussed in the draft TechNote 7b, any LPA approved by SBA before the TechNote's effective date which *expressly* permits payments of management expenses inconsistent with the policies identified in Technote 7b will control in the event of a conflict.

³ Capitalized terms not otherwise defined in this letter shall be as defined in TechNote 7b.

- 4) **Definition - Maximum SBIC Management Fee (B.2.c):** This paragraph includes language which should be added to an LPA if the SBIC chooses to use a different formula than the one specified in the TechNote.
 - 5) **Definition - Management Fee Initial Period (B.2.d):** The TechNote changes the term “Initial Investment Period” used in TechNote 7a to “Management Fee Initial Period” to be consistent with the new Model LPA’s terminology. The Management Fee Initial Period generally corresponds to a fund’s investment period, and this paragraph clarifies that SBA will not approve an extension of the Management Fee Initial Period even if SBA approves an extension of the investment period.
 - 6) **Definition - Management Fee Base (B.2.e):** This paragraph clarifies that the amount of Assumed Leverage may not exceed two times the SBIC’s Regulatory Capital or such greater amount approved by SBA. The TechNote also clarifies that in determining the Management Fee Base after the Management Fee Initial Period, the cost of loans and investments for all portfolio companies is as reported on the Form 468 minus any noncash capitalized interest, such as Payments in Kind (PIK), since such amounts do not reflect the SBIC’s financing in these companies. It further clarifies that the Management Fee Base may not exceed the highest Management Fee Base during the Management Fee Initial Period.
 - 7) **Definition – Management Fee Rate (B.2.f):** The TechNote states that if the SBIC is a drop-down fund, SBA will not approve a Management Fee Rate that exceeds that of the parent, consistent with existing SBA practice.
- b. **Paragraph C – General Management Fee Policy, Procedures and Notes**
- 1) **SBA Approval (C.1).** TechNote 7a includes language regarding Earmarked Profits and Excess Management Expenses, which applies only to SBICs issuing Participating Securities. TechNote 7b removes this language since SBA is no longer licensing such SBICs.
 - 2) **Outsourced Management Expense Activities (C.3).** SBA is aware that many SBICs outsource certain activities that SBA considers to be Management Expenses. The TechNote describes what Management Expense activities may and may not be outsourced by the SBIC. The TechNote also discusses SBA’s general expectation that such outsourced activities will be paid out of the Management Fee, but identifies the conditions under which SBA may approve an SBIC to pay such expenses directly.
 - 3) **Fees Received by SBICs and SBIC Associates (C.4).** TechNote 7a states that fees received under §§107.860 and 107.900 are supposed to benefit the SBIC by either being paid into the SBIC directly or treated as an offset. It also identified the regulatory exception for investment banking fees that meet specific conditions. TechNote 7b provides further clarification as to which entities may receive such fees and how these should be reported. Technote 7b also includes exceptions for expense reimbursements and for situations in which an SBIC co-invests with an Associate.
 - 4) **Use of Management Fees (C.5).** Both TechNote 7 and 7a stated that management fees must be used solely for Management Expenses of the SBIC; draft TechNote 7b retains this language. In addition, TechNote 7b clarifies that, 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. As a regulator of a federal credit program, SBA takes seriously such allegations or indications of regulatory violations in ensuring the reputational and financial integrity of the SBIC program.

- 5) ***Management Fee Waivers (C.6)***. Some GPs or Investment Adviser/Managers choose to waive a portion of the Management Fee and apply the waived amount to fund a portion of their capital contribution. The TechNote states SBA's existing policy that SBA will not approve an arrangement in which the party does not fund at least 50% of its contribution in cash. Starting on the effective date of this TechNote and all times thereafter, cumulative capital contributions for these parties should be at least 50% in cash at any time.
 - 6) ***Disclosures on Form 468 (C.7)***. Certain practices discussed in this TechNote, including outsourcing Management Expense activities (C.3), offsetting Management Fees with fees received under §§107.860 and 107.900, instead of paying such fees into the SBIC (C.4), and Management Fee waivers (C.6) pose challenges for SBA in determining whether the SBIC is compliant with Management Expense regulations and policies. Draft TechNote 7b includes a discussion of required disclosures for each of these practices.
4. **Request for Comments**. We request that any comments or suggestions on the draft TechNote be emailed to OII.FrontOffice@sba.gov with "Comments to Draft TechNote7b" in the subject heading no later than close of business August 4, 2017. In finalizing the TechNote, SBA will consider whether changes should be made in light of any comments or suggestions received.