

SBIC TechNotes

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Guidelines Concerning Allowable Management Expenses For Leveraged SBICs

Effective for all acceptable SBIC license applications submitted to SBA on and after April 1, 2004

Introduction

The purpose of this Policy is to describe SBA's practice in approving allowable management expenses for leveraged SBICs as required by §107.140 and §107.520 of SBA regulations. It 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 plays in a fund's performance, and in licensing new SBICs we place great emphasis on establishing that the proposed management team is qualified. We similarly recognize the importance of providing adequate compensation and economic incentives for the members of the team. However, SBA also has a statutory obligation to assure that SBICs utilizing government-guaranteed leverage are financially sound and that the government's financial interests are protected. Expense levels are an important consideration in this regard, and management fees are typically the most important expense category.

These guidelines are only for determining the maximum management expense permitted by SBA. SBA will permit any other calculation which results in a lower maximum management fee, including any lower management expenses negotiated by investors in the fund.

Management Fee Calculation

The maximum SBIC management expense allowed by the SBA will be determined in accordance with the following formula, which considers a combination of factors, including (a) age of the fund; (b) size of the fund; and (c) assets under management.

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

Management Fee Base and Management Fee Rate are defined in paragraphs A and B below, respectively.

A - Management Fee Base

The Management Fee Base varies based on whether or not the fund is in its Initial Investment Period, as set forth below.

A.1 Management Fee Base During the Initial Investment Period:

1. The Initial Investment Period for a fund commences on the earliest of the following: (a) date of license approval; (b) the first date of financing of a portfolio concern; or (c) the first date any management fee based on assumed leverage begins to accrue or is paid. For SBICs issuing Participating Securities, the Initial Investment Period for a fund ends on the earlier of (a) the date five (5) years from the start of the Initial Investment Period or (b) the date at which total private capital called to date plus total SBA Leverage issued by the SBIC equals or exceeds 80% of the sum of Unreduced Regulatory Capital plus Assumed SBA Leverage. For all other SBICs, the Initial Investment Period for a fund ends on the date five (5) years from the start of the Initial Investment Period, or any earlier date specified in the SBIC's limited partnership agreement or equivalent document. The SBIC's Assumed SBA Leverage must be consistent with the SBIC's business plan, as approved by SBA.
2. Unreduced Regulatory Capital is defined as the sum of:
 - a. Regulatory Capital at the time the fee is paid or begins to accrue (whichever is earlier). [Increases to Regulatory Capital will be recognized on the first day of the fiscal quarter in which the SBIC notifies SBA of the increase as evidenced by an executed Capital Certificate];
 - b. Any Distributions previously made under §107.1570(b) which reduced Regulatory Capital; and
 - c. 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).
3. During the Initial Investment Period, the Management Fee Base shall be
$$\text{Unreduced Regulatory Capital} + \text{Assumed SBA Leverage}$$

A.2 Management Fee Base After the Initial Investment Period:

After the Initial Investment Period, the Management Fee Base shall be the cost of loans and investments for all "active" portfolio companies. An "active" portfolio company is defined as a company in which the SBIC has not written off its investment and which remains an ongoing concern. Companies 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. 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).

B - Calculation of Management Fee Rate

The maximum Management Fee Rate is dependent upon the Management Fee Base as follows:

- a. If Management Fee Base is less than or equal to \$60 million, then the Management Fee Rate is 2.5%
- b. If Management Fee Base is greater than \$60 million and less than \$120 million, then the Management Fee Rate is:

$$(2.5\% - (.5\% \times ((\text{Management Fee Base} - \$60 \text{ million})/\$60\text{million})))$$

- c. If Management Fee Base is greater than or equal to \$120 million, the Management Fee Rate is: 2%

Worksheets are provided to help you calculate expenses using this formula.

General Management Fee Policy Notes:

There are several other considerations in SBA's approval of management expenses that should be noted as described below.

- (1) It must be emphasized that nothing in this memorandum eliminates your obligation to obtain specific SBA approval of your management fees as required by Regulations §107.140 and §107.520. Similarly, neither this formula nor the amount that might actually be approved by SBA modifies the computation of Earmarked Profit and Excess Management Expense under §107.1510(d)(2)(i)(A). Furthermore, for the purpose of computing Excess Management Expense, you must use the gross management fee computed under your approved management fee formula, before any offsets for fee income earned by Associates (see item (6) below).
- (2) The SBIC's Assumed SBA Leverage must be consistent with the SBIC's business plan, as approved by SBA.
- (3) Where management fees are being prepaid by the SBIC, the period covered should not exceed three months.
- (4) The effect of increases in Unreduced Regulatory Capital on management fees should 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. Such increases cannot be applied retroactively to previous quarters. The effect of decreases in Unreduced Regulatory Capital must be recognized as of the first day of the fiscal quarter in which the decrease occurs.
- (5) Amounts received as management fees must be used solely for management expenses of the SBIC (as defined in § 107.520(a)). They cannot be used for unrelated activities such as organizing a second fund.
- (6) All fees described under § 107.860 and fees earned by SBIC associates under § 107.900 are supposed to benefit the SBIC. Accordingly, such fees must either be paid directly to the SBIC or treated as an offset to the management fee. *Exception:* This 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.
- (7) The formula outlined in this policy assumes a stand-alone license which bears all of the expenses of its management. Where such expenses are shared with another institution or entity, the allowable expenses for the licensee should be reduced appropriately.
- (8) Lastly, you should remember that management fees are also controlled by your partnership agreement, and the above formula can only be used if the partnership agreement permits it. SBA will permit any other calculation which results in a lower maximum management fee, including any lower management expenses negotiated by investors in the fund. The SBA will not approve changes to partnership agreements that retroactively raise management fees to apply to previous periods, even if such fees fall within the maximum management fees identified in this policy.