
Guidelines for SBA Approval of Conflict of Interest Transactions

Within the SBIC program, conflict of interest transactions involving an SBIC and an Associate represent serious potential regulatory and financial problems. SBIC Regulations at 13 CFR 107.730 address conflict of interest transactions, and the requirements for SBA approval of certain conflict of interest transactions. The purpose of this TechNote is to discuss some of the factors that SBA will consider in reviewing requests for conflict of interest exemptions.

Excerpts from Relevant SBA Regulations

The definition of Associate is found at 13 CFR 107.50 and is included in this TechNote for ease of reference

Associate of a Licensee means any of the following:

- (1)(i) An officer, director, employee or agent of a Corporate Licensee; (ii) A Control Person, employee or agent of a Partnership Licensee; (iii) An Investment Adviser/Manager of any Licensee, including any Person who contracts with a Control Person of a Partnership Licensee to be the Investment Adviser/Manager of such Licensee; or (iv) Any Person regularly serving a Licensee on retainer in the capacity of attorney at law.
- (2) Any Person who owns or controls, or who has entered into an agreement to own or control, directly or indirectly, at least 10 percent of any class of stock of a Corporate Licensee or a limited partner's interest of at least 10 percent of the partnership capital of a Partnership Licensee. However, a limited partner in a Partnership Licensee is not considered an Associate if such Person is an entity Institutional Investor whose investment in the Partnership, including commitments, represents no more than 33 percent of the partnership capital of the Licensee and no more than five percent of such Person's net worth.
- (3) Any officer, director, partner (other than a limited partner), manager, agent, or employee of any Associate described in paragraph (1) or (2) of this definition.
- (4) Any Person that directly or indirectly Controls, or is Controlled by, or is under Common Control with, a Licensee.
- (5) Any Person that directly or indirectly Controls, or is Controlled by, or is under Common Control with, any Person described in paragraphs (1) and (2) of this definition.
- (6) Any Close Relative of any Person described in paragraphs (1),(2), (4), and (5) of this definition.
- (7) Any Secondary Relative of any Person described in paragraphs (1), (2), (4), and (5) of this definition.
- (8) Any concern in which--

- (i) Any person described in paragraphs (1) through (6) of this definition is an officer; general partner, or managing member; or
- (ii) Any such Person(s) singly or collectively Control or own, directly or indirectly, an equity interest of at least 10 percent (excluding interests that such Person(s) own indirectly through ownership interests in the Licensee).

(9) Any concern in which any Person(s) described in paragraph (7) of this definition singly or collectively own (including beneficial ownership) a majority equity interest, or otherwise have Control. As used in this paragraph (9), "collectively" means together with any Person(s) described in paragraphs (1) through (7) of this definition.

(10) For the purposes of this definition, if any Associate relationship described in paragraphs (1) through (7) of this definition exists at any time within six months before or after the date that a Licensee provides Financing, then that Associate relationship is considered to exist on the date of the Financing.

(11) If any Licensee has any ownership interest in another Licensee, the two Licensees are Associates of each other.

The definitions of Control and Control Person are also found at 13 CFR 107.50 and are included here:

Control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a Licensee or other concern, whether through the ownership of voting securities, by contract, or otherwise.

Control Person means any Person that controls a Licensee, either directly or through an intervening entity.

A Control Person includes:

- (1) A general partner of a Partnership Licensee;
- (2) Any Person serving as the general partner, officer, director, or manager (in the case of a limited liability company) of any entity that controls a Licensee, either directly or through an intervening entity;
- (3) Any Person that
 - (i) Controls or owns, directly or through an intervening entity, at least 10 percent of a Partnership Licensee or any entity described in paragraphs (1) or (2) of this definition; and
 - (ii) Participates in the investment decisions of the general partner of such Partnership Licensee;
- (4) Any Person that controls or owns, directly or through an intervening entity, at least 50 percent of a Partnership Licensee or any entity described in paragraphs (1) or (2) of this definition.

13 CFR 107.730 contains the relevant provisions which pertain to "Financings which constitute conflicts of interest." You should refer to the entire section when contemplating a transaction which may involve Associates or other potential conflicts of interest. The following paragraphs of 107.730 are excerpted here because they deal with the conflict of interest issues that occur most frequently in the SBIC program: 13 CFR 107.730 (a) contains the following language:

- (a) General Rule: you must not self-deal to the prejudice of a Small Business, the Licensee, its shareholders or partners, or SBA. Unless you obtain a prior written exemption from SBA for special instances in which a Financing may further the purposes of the Act despite presenting a conflict of interest, you must not directly or indirectly:
 - (1) Provide Financing to any of your Associates.

(2) Provide Financing to an Associate of another Licensee if one of your Associates has received or will receive any direct or indirect Financing or a Commitment from the Licensee or a third Licensee (including financing or Commitments received under any understanding, agreement, or cross dealing, reciprocal or circular arrangement).

(3) Borrow money from:

(i) A Small Business Financed by you;

(ii) An officer, director or owner of at least a 10 percent equity interest in such business;
or

(iii) A Close Relative of any such officer, director or equity owner.

(4) Provide financing to a Small Business to discharge an obligation to your Associate or free other funds to pay such obligation. This paragraph (a) (4) does not apply if the obligation is to an Associate Lending Institution and is a line of credit or other obligation incurred in the normal course of business.

(5) Provide Financing to a small business for the purpose of purchasing property from your Associate, except as permitted under §107.720(h).

13 CFR 107.730 (d) states as follows:

(d) (1) Financings with Associates requiring prior approval. Without SBA's prior written approval, you may not Finance any business in which your Associate has either a voting equity interest, or total equity interests (including potential interests) of at least five percent.

(2) Other financings with Associates. If you and an Associate provide Financing to the same small business at the same time or at different times, you must be able to demonstrate to SBA's satisfaction that the terms and conditions are (or were) fair and equitable to you, taking into account any differences in the timing of each party's financing.

(3) Exceptions to Paragraphs (d) (1) and (d) (2) of this section. A financing that falls into one of the following categories is exempt from the prior approval requirement in paragraph (d) (1) of this section or is presumed to be fair and equitable to you for the purposes of paragraph (d) (2) of this section, as appropriate:

(i) your Associate is a Lending Institution that is providing financing under a credit facility in order to meet the operational needs of the Small Business, and the terms of such financing are usual and customary.

(ii) Your Associate invests in the Small Business on the same terms and conditions and at the same time as you.

(iii) Both you and your Associate are leveraged licensees, and both have outstanding Participating Securities or neither has outstanding Participating Securities.

(iv) You have no outstanding Leverage and do not intend to issue Leverage in the future, and your Associate either is not a Licensee or has no outstanding Leverage and does not intend to issue Leverage in the future.

Lastly, 13 CFR 107.730 (g) imposes the following requirement with respect to exemptions granted under 107.730 (a):

Public Notice. Before SBA grants an exemption under this §107.730, you must publish notice of the transaction in a newspaper of general circulation in the locality most directly affected by the transaction, and furnish a certified copy to SBA within 10 days of publication. SBA will publish a similar notice in the FEDERAL REGISTER.

In December 2001, a legislative change had the effect of ending the requirement for local publication of notice (§ 3 of P.L. 107-100, approved Dec. 21, 2001 (115 U.S. Stat. 966)). However, SBA is still required

to publish notice of the transaction in the FEDERAL REGISTER. The format for this notice is included at the end of this TechNote. In accordance with the legislative change, SBA will write new regulations ending the requirement for local publication of the notice. Until such revised regulations take effect, SBA will consider requests for waiver of the local notice requirement found at 13 CFR 107.730 (g).

SBA Review of Conflict of Interest Transactions

There are various types of conflict of interest transactions that require SBA approval under 13 CFR 107.730. SBICs should be aware of the distinction between financing an Associate (governed by 13 CFR 107.730(a)) and co-investing with an Associate (governed by 13 CFR 107.730(d)). The former requires "a prior written exemption from SBA for special instances in which a Financing may further the purposes of the [Small Business Investment] Act despite presenting a conflict of interest", and requires public notice of the exemption being sought. The latter may or may not require SBA's prior written approval, and in any case does not require public notice. It is possible for both §§107.730 (a) and 107.730 (d) to be applicable to a particular transaction; in such cases SBA applies the requirements of §107.730 (a).

Financing an Associate. SBA's primary concern in reviewing transactions that involve financing of an Associate is that the managers of an SBIC may enter into such a transaction with motives that do not include the maximization of the SBIC's profits, and thus may accept terms inferior to those that would have resulted from an arm's length transaction. In considering whether to approve the financing of an Associate, SBA reviews the terms to determine whether they are fair to the SBIC, the SBIC's investors, the small concern, and SBA. The essential consideration is whether the terms are comparable to those that would be obtained in a similar transaction not involving an Associate.

SBA is also concerned about the appearance of impropriety in Associate financing transactions. This is particularly true in cases where the circumstances may create a strong perception that the transaction is motivated primarily by personal relationships. For this reason, SBA generally will not grant a conflict of interest exemption for the financing of a business that is owned or operated by individuals who are relatives of persons owning or operating the SBIC.

Some "Associate financings" are also "financings with Associates." For example, consider an SBIC that has one or more Associate venture funds; these could be Associates by virtue of common management, common ownership, family relationships, or other factors. The SBIC wishes to invest in a small business in which its Associate venture funds have previously invested and in which these Associates have at least a 10 percent ownership interest. In this case, the small business is considered an Associate of the SBIC, pursuant to paragraph (8) of the Associate definition in §107.50. Therefore, the proposed financing would require a conflict of interest exemption under § 107.730 (a); this is true even though §107.730 (d)(1) appears to be applicable.

Financings with an Associate. These are transactions where an SBIC and its Associate invest in the same small business, either at the same time or at different times, but where the small business is not considered an Associate of the SBIC. The general rule in §107.730 (d)(1) is that SBA's prior written approval is required if, at the time of the SBIC's investment, the Associate has an ownership interest of at least 5 percent. In cases where the Associate does not have an ownership interest of at least 5 percent, the applicable regulation is §107.730 (d)(2), under which the SBIC must be able to demonstrate that it received terms that were fair and equitable, i.e., that the SBIC was not disadvantaged relative to its Associate. Even though SBA's prior approval is not required under §107.730 (d)(2), SBICs may wish to consult SBA before making the investment, particularly if the evaluation of the relative terms may involve considerable subjective judgement. SBICs should also be aware of the "safe harbor" provision in

§107.730 (d)(3); if one of these conditions is satisfied, SBA approval is not required under §107.730 (d)(1) since the terms are presumed to be fair and equitable to the SBIC for purposes of §107.730 (d) (2).

Factors considered by SBA in reviewing requests for exemptions or prior approval. Whether a proposed transaction is an "Associate financing" or a "financing with an Associate", SBA's objective is essentially the same—to determine whether the transaction is consistent with the purposes of the SBIC program and is equitable to all parties, including SBA. However, because of the complexity and generally unique characteristics of individual financings undertaken by SBICs, it is not possible to develop one set of criteria applicable for SBA approval of all transactions involving conflicts of interest. It has been our experience that no two financings are identical, in terms of the structure of the transaction, the roles of the parties involved, or the relative amounts of financing provided by third parties. Therefore, it is not possible to create a "safe harbor" for transactions of this type. SBA's decision will be based on the facts and circumstances of each investment.

In order to provide some guidance, SBA has compiled a list of factors that it considers in reviewing a proposed transaction. This list focuses primarily on situations in which an Associate of the SBIC has previously invested in a prospective portfolio company. The list is not all-inclusive and other facts will be considered in individual cases. Also, it is not expected that the transaction must comply with all of the factors below in order to be considered fair. Our decision is based on the totality of the facts and circumstances of the investment. The factors SBA considers include the following:

1. With respect to the Associate who is an existing investor in the small business, is the Associate a direct investor in his own name or through a nominee, personal holding company, or estate, trust, or family member or is the Associate an indirect investor via a fund? If an indirect investor via a fund, is the Associate a control party of that fund (is your Associate a general partner, does the Associate have veto power over new investments or exit decisions, or is the Associate one of the largest monetary investors)? The more passive the role of the Associate and the lower the dollar value of the Associate's investment percentage in the fund, the stronger the likelihood of approval. For example, SBA would not approve a transaction in which the Associate was the sole owner of the company receiving the financing. Conversely, fewer problems arise if your Associate was a limited partner of a large fund, and the Associate's investment represented 10% or less of a fund's capital, and in all other respects the Associate was a passive investor.
2. Is the Associate continuing its investment position in the small business, or is your Associate planning to exit? Remaining an investor is perceived favorably. Your Associate's departing is considered a negative factor, since the SBIC's financing may in some way provide the liquidity for the Associate's exit.
3. Does the Associate benefit, either directly or indirectly, from any part of the SBIC's financing? For example, this could be in the form of a redemption of the Associate's investment, payments under a contract, or dividends on the Associate's class of stock.
4. Is the Associate participating in this round of financing? This is considered a favorable factor. If not, why not? It is not considered prejudicial if the Associate has already reached its dollar limit on individual investments (comparable to SBA's Overline limit), or is in a wind down phase and as a consequence is no longer making new or follow-on investments.
5. How do the terms of the SBIC's investment compare to the Associate's terms? If less favorable, why? One reasonable explanation would be that considerable time has passed since the

Associate's investment; the portfolio company has made good progress, and commands a higher price/valuation, and/or better terms now.

6. Are there any unrelated, new, sophisticated investors involved in the SBIC's round of financing? This tends to indicate the round is an "arm's length" transaction. In order to substantiate this premise, however, there should be a significant amount of money raised in this round, and the unrelated, new investor's participation should represent a significant portion of the round. Lastly, the new investor's entry should represent a financial investment and not a strategic investment made to gain access to technology, market presence, or other non-financial reasons. While not a requirement, it would be helpful if the unrelated, new investor led the financing round and set the terms of the financing in which the SBIC participates.

7. Does the contemplated financing result in effective control of the portfolio concern by the SBIC and its Associate? Transactions with this result require more compelling justification and are subject to increased scrutiny by SBA.

NOTICE
U.S. SMALL BUSINESS ADMINISTRATION

(License No. xx/xx-xxxx)

Notice Seeking Exemption Under Section 312 of the Small Business Investment Act, Conflicts of Interest

Notice is hereby given that _____, a Federal Licensee under the Small Business Investment Act of 1958, as amended ("the Act"), in connection the financing of a small concern, has sought an exemption under section 312 of the Act and section 107.730, Financings which Constitute Conflicts of Interest of the Small Business Administration ("SBA") rules and regulations (13 CFR 107.730 (2001)) proposes to provide equity/debt security financing to _____ . The financing is contemplated for _____.

The financing is brought within the purview of Sec. 107.730(a)(1) of the Regulations because _____, an Associate of _____, currently owns greater than 10 percent of (or the nature of the relationship if other than 10 percent ownership) and therefore is considered an Associate of _____ as defined in Sec. 107.50 of the regulations.

Notice is hereby given that any interested person may submit written comments on the transaction to the Associate Administrator for Investment, U.S. Small Business Administration, 409 Third Street, SW, Washington, DC 20416.

[NAME]
Associate Administrator for Investment

Date