



THE U.S. SMALL BUSINESS ADMINISTRATION'S IMPACT ON THE FUTURE OF GOVERNMENT FUNDED INNOVATION

EXECUTIVE SUMMARY

The last six years have been a time of great change for the United States. The country has faced economic downturn and threats from abroad. As would be expected the federal government has called on the private sector to help meet many of these challenges. Big business has provided help but a less traditional group, venture capital-funded small businesses, are playing a larger role in creating jobs and developing new innovative products. These products range from health care advances to new military and intelligence applications. The Bush Administration has taken note and is proactively working with these small innovators to develop new technologies and to create needed high paying jobs.

Ironically during this same period of time, starting in 2001, there has been a seemingly insignificant chain of events that threatens to limit the positive impact of venture-backed small businesses on government's needs. A bureaucratic change taking place within the Small Business Administration (SBA) runs in direct opposition to the efforts of the Administration to promote a public/private partnership to address many of the challenges facing this country. Some of the most productive, innovative small businesses in the country are being disqualified from participating in crucial federal programs because they receive funding from venture capital companies (VCCs)¹. In other words, because these small businesses have proven to VCCs that their respective products have great market potential and should be funded, they may no longer qualify as small businesses in the eyes of the SBA.

Specifically, more and more venture backed small businesses are being denied access to Small Business Innovation Research (SBIR) grants and more recently have been prevented from participating in the government contracting and procurement process as small businesses. These changes are the result of reinterpretation of existing regulation by the SBA. The SBA has ruled that small businesses that are majority owned by VCCs do not qualify as small businesses under current regulation. It is important to note that prior to 2001 this reinterpretation of the rule small businesses that were majority owned by VCCs participated in these programs freely and with great success accounting for approximately 20 percent of the SBIR awardees.

¹ In these provisions VCC has the same definition as a venture capital operating company (VCOC), as defined in U.S. Department of Labor regulations (69 Fed. Reg. 70197 (December 3, 2004), as amended by 70 Fed. Reg. 2976 (January 19, 2005).

The National Venture Capital Association (NVCA) believes that the SBA's position on venture backed small businesses puts the SBA in conflict with the broader policies of the Administration. We believe the reinterpretation of existing regulation disqualifying venture capital majority backed companies stems from confusion over how the venture community works and the role VCCs play in the companies in which they invest (portfolio companies). Furthermore, it is our hope that there are those within the SBA that share the opinion that venture backed small businesses have a vital role to play in these small business programs as well as in the larger U.S. economy.

Following is a summary of the changes that have taken place within the SBA to limit the participation of venture backed small businesses in small business programs. In contrast to the SBA's efforts to limit ventured small business participation, the paper will also highlight three successful initiatives within the Executive Branch that promote small business and venture capital participation in ongoing efforts to grow the economy and meet specific needs of the federal government. Finally we will discuss the workings of the venture capital industry; specifically who venture capitalists are, the source of venture capital dollars and the positive impact VCCs exert on the U.S. economy.

HARMFUL REGULATORY CHANGES AT THE SMALL BUSINESS ADMINISTRATION

For 20 years, venture backed small businesses have participated in the SBA programs designed to promote technological innovation and encourage participation by small businesses. All of this has changed over the past five years due to SBA's decisions that small businesses that are majority owned by venture capital companies no longer qualify for SBIR grants and more recently that many majority venture backed small business may no longer qualify to compete for federal contracts under small business set asides. These recent developments have already had and will continue to have a chilling affect on the federal government's ability to leverage the innovation and economic growth potential of many of the most promising small businesses in the country.

Government Contracts for Small Businesses

In the second half of 2006 the Small Business Administration's Office of Public Contracting issued a size determination stating that a specific venture-backed small business (Company) was ineligible to compete for a Homeland Security government contract set aside for small businesses. The SBA's office of contracting determined that the Company was not a small business because it exceeded the 1500 employee threshold that defines a small business in this Company's particular industry.

The Company in question clearly employees less than the maximum allowable 1500 workers. To disqualify the Company from participation the SBA took the unprecedented and arguably flawed position that because the Company was majority owned by a VCC, the employees of the VCC and its other portfolio companies should be counted when determining the size of the entity competing for the government contract. To the

NVCA's knowledge this Affiliate Rule has never been used before to disqualify a venture backed small business from competing for government contracts.

On the technical merits it is difficult to understand how the SBA justifies their position when it directly contradicts language in the Small Business Investment Act which seems to address this very issue. Section 103 of the SBIA states:

an investment by a venture capital firm...

(A) shall not cause a business concern to be deemed not independently owned and operated regardless of the allocation of control during the investment period under any investment agreement between the business concern and the entity making the investment;

(B) shall be disregarded in determining whether a business concern satisfies size standards established pursuant to section 3(a)(2) of the small business act

From this language it seems clear that ownership by a VCC would not trigger the Affiliation Rule for programs that were created under the SBIA and furthermore interpretation by the SBA to the contrary runs in direct opposition to the intent by Congress to encourage venture capital funding of small businesses.

On a more general level, the size determination by SBA's office of contracting is at best counterproductive to the efforts of the federal government to acquire the goods and services it needs. Many of the high-tech products developed by small business can not be developed without financing from the venture capital industry. By excluding small businesses that develop capital intensive products from competing in the small business contracts process, the SBA is not only hindering the growth of these small businesses by making them compete against large corporations for contracts but it is limiting the ability of the private sector to meet the needs of the federal government. It also limits the choice of entrepreneurs to access capital since accepting capital from a VCC would force them to drop their option of accessing development funds from SBIR.

SBIR Grants

The Small Business Innovation Research (SBIR) program was created by the Small Business Innovation Development Act of 1982 (SBIDA). Two of the main purposes of the legislation were to stimulate technological innovation and to use small business to meet Federal research and development needs².

To be eligible for an SBIR award, at least 51% of a company must be owned and controlled by one or more "individuals" who are citizens of the United States.³ For 20

² S. Rep. No 97-194, 97th Cong., 1st Sess. 1981, reprinted in 1982 U.S.C.A.A.N. 512.

³ The NVCA acknowledges SBA's efforts to address this issue by allowing entities to hold majority interest in an applicant as long as that entity is majority owned by individuals. This fix does not remove the hurdle because investors who create the investing entity or fund or not always individuals or families. These

years, VCCs were considered to fall within the definition of “individuals” until an Administrative Law Judge’s (ALJ) ruling reinterpreted the definition to exclude venture capital companies in January of 2001. In the decision the ALJ ruled that a firm that is otherwise eligible for an SBIR award is disqualified because it is wholly owned by another entity. At issue in that decision was whether or not the SBIR requirements that an applicant be majority owned and controlled by U.S. individuals should be interpreted to mean only natural persons, thereby excluding entities such as corporations. This was the first time this issue had been presented for review, and despite the lack of statutory or historical Congressional support, the ALJ ruled that “individual” should indeed mean “natural persons.” In fact, the ALJ specifically discounted the statutory uses of the word “individual” where it was defined to include entities, while simultaneously acknowledging that the legislative history of the SBIR program discusses only generally the need to reverse the decline in American technological innovation and competitiveness and that Congressional reports do not discuss individual ownership of SBIR awardees as opposed to entity ownership.

In addition to asking that the Affiliation Exclusion discussed in the previous Contracts section also be applied to SBIR applicants, we request that the SBA propose a rule that the term “individuals” in the current regulations⁴ be defined to include both natural persons and VCCs. We believe that the SBIR eligibility requirements should not differentiate between natural persons and other legally recognized entities with respect to VCCs. There is no statutory or legislative support, including SBA’s own legislative history, for the regulations which limit eligible awardees under the 51% Rule to those owned by individuals. Congressional intent in passing SBIDA was to increase the amount of Federal research and development support for highly innovative small businesses, bolstering the competitive position of the United States. Therefore the current interpretation of the 51% Rule is not only inconsistent with SBIDA but on a larger policy level the rule reinterpretation is in direct conflict with the efforts of the Bush Administration to promote innovation and economic growth through a public/private partnership between government and the private sector.

SBA’S REGULATORY CHANGES CONTRADICT THE EXECUTIVE BRANCHES EFFORTS TO PROMOTE INNOVATION

While the controversy continues over whether or not venture backed small businesses should be allowed to compete for SBA program dollars, the Administration is focused on marshalling the economic resources of the federal government to grow the economy and spur innovation. The following three programs and initiatives are examples of the Executive Branch’s efforts to foster a public-private partnership to further the country’s economic goals. This partnership is dependent on the growth of small, innovative,

funds also include dollars from private and public pension funds, financial and insurance sources, individuals and families, endowments and foundations and to a small degree, corporations and therefore are not individuals.

⁴ 13 CFR 121.702.

venture-backed businesses. The NVCA believes the aforementioned challenge by the SBA clearly represents an obstacle to the Administration's efforts.

In early 2006, the Administration launched a broad reaching competitive initiative designed to fuel innovation in the U.S. economy. The Executive Branch believes that only by marshalling the combined resources of both the public and private sectors can the country hope to stay competitive in the Global Economy and meet the needs of Defense Department and Intelligence communities by providing them the technological tools they seek.

American Competitiveness Initiative

The *American Competitiveness Initiative* is the White House's economic proposal recognizing that innovation is the key competitive advantage of the U.S. This innovation is driven in large part by collaborative efforts between the federal government and the private sector. By bolstering this proven working relationship, the Bush Administration hopes to secure the U.S.'s position as the leading economic force in the Global Economy. To that end, the Administration has proposed a budgetary increase for the National Science Foundation and the Departments of Energy, Commerce and Defense. This new investment of \$50 billion by the federal government is targeted for high-leverage, innovation-enabling research that will compliment shorter-term research performed by the private sector.⁵ By offering this increase the Administration hopes to leverage federal dollars by working in concert with the private sector to bring basic research to where it can be funded and developed into viable products which will grow the U.S. economy and benefit U.S. workers.

Venture backed small businesses play a large role in developing basic research into commercially viable products. The federal government invests in basic research with the understanding that the most innovative companies will be able to move a research concept down the development chain to the market place. The Government is well aware that much of this innovation will come from small business as well as the more traditional large companies. Because of the cost of developing this research into usable technology, small businesses have relied and will continue to rely heavily on VCC's to fund this development. The current interpretation impacts small ventures firms in undercapitalized regions the most since these firms are more likely to encourage their portfolio companies to access SBIR funding for product development.

Department of Defense-Defense Venture Catalyst Initiative

The need for private sector involvement runs through many of the agencies and departments of the federal government. No where is this need more apparent or crucial than in the Department of Defense (DoD). DoD recognizes that the private sector in general, and the venture capital community specifically, is uniquely qualified to help the military identify and develop commercial technologies. DoD has developed a program called the Defense Venture Catalyst Initiative (DeVenCI) designed to integrate the

⁵ The American Competitiveness Initiative, February 2006

venture capital community into the process of identifying and meeting the needs of the armed forces.⁶

Venture capitalists bring a unique perspective to the military because they fund small, high-risk companies developing technologies that potentially have military applications. But because many of these small businesses are focused solely on the commercialization of their products, they have neither the expertise nor resources to navigate the government procurement process. Until the inception of DeVenCI many of these small businesses and their innovative products went unnoticed by the Pentagon.

Enter the venture capitalist. Senior Pentagon leadership saw the benefits of public private partnership to spur innovation after the September 11th attacks. The leadership recognized that venture capitalists were funding many of the small businesses driving innovation. These small companies with the help of VCCs were working on technologies that larger corporations were unwilling or unable to develop. The leadership also recognized that the VCC's, with their diverse portfolio of companies provided the best way to access these promising small businesses. In November 2001, a pilot project was initiated bringing together a small group of VCCs to identify promising technologies in the private sector. Since the project's inception the Pentagon has identified 15 new technologies that are now in use by the military.⁷ Additionally because of VCC's interaction with government, a large number of small companies are now aware of the contracts and procurement process and the positive role their small business can play in developing new military applications.

In-Q-Tel

Possibly the most striking example of the federal government's efforts to leverage the expertise of the private sector is In-Q-Tel (IQT). In 1999, the Central Intelligence Agency (CIA) recognized that: (a) a great deal of innovation was being developed in the commercial markets by young innovative companies and (b) the CIA needed a way to engage with these young innovative companies.^[1] To that end, IQT was founded as an independent, private, not-for-profit firm to identify, develop and deploy cutting edge technologies for the CIA and the U.S. Intelligence Community.

The IQT strategic investment model combines equity investment with the ability to contract to enhance and accelerate technology development. This model, coupled with a commitment to solutions transfer to successfully introduce innovative technologies to serve the nation, is the key to IQT's impact. With significant resources dedicated to working alongside the Intelligence Community, IQT has provided a unique and effective vehicle for emerging companies to introduce their solutions to a traditionally challenging customer set. To date, IQT has delivered more than 130 technology solutions to the Intelligence Community and cultivated a network of over 200 VCs to help the Agency identify new technologies.

⁶ <http://devenci.dtic.mil/index.html>

⁷ <http://devenci.dtic.mil/pdf/Overview.pdf>

IQT is another example of the importance the federal government places on the role of venture-backed small businesses to provide it with new, innovative technologies. IQT is another resource the government can use in addition to traditional governmental contracting to provide the necessary access to innovative products. One of the criteria used by IQT to decide whether or not to invest in a particular business is to ask the question, “Can the Intelligence Community and, indeed, the country, afford not to have this new capability?” IQT exemplifies efforts to create a productive working relationship between government agencies and innovative businesses.

VENTURE CAPITAL: AN OVERVIEW

Venture Capital while becoming more prevalent around the world is truly an American invention. The high risk and high reward structure in which venture capitalists operate typifies America’s willingness to take significant risk in the hopes of producing a truly innovative, marketable product. According to a 2004 Global Insight study, venture-backed companies accounted for 10.1 million jobs and \$1.8 trillion in revenue in the United States in 2003.

Workings of Venture Capital

Venture capitalists (VCs) are investors in companies. They do not manage or run companies. Venture capitalists are individuals that raise investment dollars from a number of different sources to create a fund. This fund which is managed by the VC or General Partner (GP) invests in portfolio companies in the hopes of growing the company from its early stage into a viable business that can be taken public or acquired by another entity. The purpose of the investment in the portfolio company by the VC or General Partner is to generate a significant return on investment for the initial group of investors or limited partners (LPs).

The investors of the limited partnerships are usually pension plans, foundations, trusts, and accredited investors. They are called limited partners because they are exempt from liability because they neither exert control of the day-to-day operations of the VC fund nor participate in making investment decisions for the fund. The VC or GP runs the day-to-day operations of the fund and makes its investment decisions. It is important to note that while the VC does control the fund which invests in the portfolio company or small business, the VC does not control day-to-day operations of the small business in which the fund invests. The VC represents the investors on the board of directors and acts as a resource for the company’s management team. The management team is responsible for running the company.

VC Investment does not Equate to Corporate Investment

A common argument of why venture capital backed small businesses should be excluded from participating in SBA programs is that VC investment is really just corporate investment and that SBA programs were not designed to subsidize small businesses that are majority owned by large corporations. This argument is without merit because the vast majority of VC dollars comes from non-corporate sources. In 2003, for example,

VC funding sources were as follows: Private and Public Pension Funds (42%), Financial and Insurance (25%), Endowments and Foundations (21%), Individuals and Families (10%) and Corporate Investment excluding pensions (2%)⁸. These numbers clearly show that corporate dollars play a very minor role in total venture capital dollars invested.

Research and Development Vs Commercialization

Why does a small business that has received venture backing need to participate in SBA programs? This is a fair question for those not versed in the business model used by VCCs. A VCC invests in a small business, exposing itself and its investors to very high risk, to generate an above average rate of return. In order to generate a return, the portfolio company must move towards the commercialization of a product. For this reason, VC dollars are focused on the commercialization of existing technology. They do not fund early stage research. Therefore, a small business must leverage other sources of financing to bring research to the stage where it can be commercialized by a VC. This source can come from the SBIR program or if a company has existing product or service, from contracting with the federal government. Another way to think of how a VC backed company operates is to consider a small business with two different products being developed. One product is at the early stage of development and is being funded by SBA related dollars or other non-VC financing sources, the second product, which is near commercialization is being funding almost entirely by VC dollars. Without the non-VC funding source many viable, innovative technologies would linger “on the shelf” because they would not reach the stage where they could be commercialized.

Venture Capital’s Impact on the U.S. Economy

Venture-backed companies are critical to the U.S. economy in terms of creating jobs, generating revenue and fostering innovation. In terms of global competitiveness, the entrepreneurial segment of the economy is the true differentiator for America. U.S. companies originally funded with venture capital now represent 11 percent of annual GDP and employ over 10 million Americans.

CONCLUSION

Venture capital backed small businesses have a proven track record of creating jobs and promoting innovation in the U.S. For the last 20 years these companies, with the help of the federal government and the capital markets have played a disproportionately large role in growing the U.S. economy. Companies such as Cisco, Apple, Genentech and Google all started out as venture backed small businesses.

The NVCA asserts that the SBA’s current interpretation of the Affiliation Rule and the 51% individual ownership criteria has and will continue to cut off a critical funding source to some of this country’s most promising small businesses. Now more than ever small business needs multiple funding sources to turn a concept into a marketable product. Instead of hindering this process, the SBA should redouble its efforts to help all small businesses grow.

⁸ 2004 NVCA Yearbook, Thompson Financial using 2003 data

The NVCA asks that the SBA recognize the fact that venture-backed small businesses are truly small business that should remain eligible for SBA programs. To that end we ask that the SBA revisit the regulatory changes that have hindered venture-backed small businesses from competing for grants and now contracts. Until recently, SBA programs have worked to leverage tax payer dollars by promoting the best, most likely to succeed technologies the small business community has to offer. By returning to this successful model, the SBA will help the entire small business community grow which in turn will help strengthen the country as a whole.