

NVCA Seeks Legislative Solution on Small Business Innovation Research (SBIR) Grants

The future of venture backed company involvement in the SBIR grant program continues to be hotly debated in Washington and across the country.

Background

The current dispute over venture capital funding in the context of the SBIR program began in January, 2001, when the Small Business Administration (SBA) Office of Hearings and Appeals issued a ruling against the majority ownership of SBIR companies by VC firms. This ruling was based on the appeal of CBR Laboratories, Inc., to the rejection of its application for SBIR funding by the NIH. CBR Laboratories' grant application had been rejected because a VC firm held a controlling interest (i.e., more than 51 percent) in CBR Laboratories. The ruling made by the Administrative Law Judge stated that VC firms were not "individuals," i.e., "natural persons," and therefore SBIR agencies could not give SBIR grants to companies in which VC firms had a controlling interest.

Recent Developments

SBA Slow to Move

On April 1, 2005, NVCA submitted comments to the SBA on its proposed rulemaking affecting SBIR eligibility. NVCA's comments requested that SBA extend an exception to the 51% Rule to include VCOC's in the definition of "individuals" and also to provide a proposed exclusion from affiliation with VCOC's in determining small business eligibility. SBA made it clear that it would take at least 3 years if they were to make an administrative change to the proposed rule. NVCA's position is that 3 years is an unacceptable time frame for a change to be implemented and believes legislation is necessary at this point to ensure that venture backed companies again become eligible to participate in the program. NVCA's comments submitted to the SBA are posted on the website (www.nvca.org).

In June, the SBA finished a two month series of hearings across the country on the topic of SBIR participation. NVCA notified members in the states selected for these hearings, and several members and portfolio companies testified expressing concern about SBA's ruling.

Congressional Activity

Also in June, the Senate and House introduced bi-partisan legislation (S. 1263 and H.R. 2943) that clarifies the SBIR eligibility requirements for venture backed start up companies by amending the Small Business Act to include a definition allowing any business concern that is at least 51% owned and controlled by one or more individuals and/or venture capital companies to participate in the program. The legislation also limits

the size of business concern by including a definition that no affiliated venture capital company shall own or control more than 49% of the business concern, nor be controlled by a company which is not a small business as defined by the SBA. NVCA and BIO support this legislation and are working with the Senate and House sponsors to shore up support for the legislation.

There have been two recent hearings in the House of Representatives. On June 28th, the House Science Subcommittee on Environment, Technology and Standards held a hearing titled: Small Business Innovation and Research: What is the Optimal Role for Venture Capital? On July 27th, the House Small Business Subcommittee on Rural Enterprises, Agriculture and Technology Policy held a hearing titled: The Importance of the Biotechnology Industry and Venture Capital Support in Innovation. **Dan Broderick, Mason Wells Biomedical Fund and Board Member of the NVCA testified on behalf of NVCA.** Dan Broderick's testimony is posted on NVCA's website (www.nvca.org).

Both hearings were a spirited debate on the role of venture capital in the biotech industry.

Opponents contend that VC firms are often run by large corporations. Therefore, they argue that small businesses that are controlled by VC firms should not be seen as independent small businesses in need of special research funding, but rather as arms of large corporations that do not merit SBIR support. They argue that if SBA regulations allowed more VC-backed companies to apply for SBIR grants, they would crowd out completely independent small research companies run or owned by individuals. They also argue that SBIR-eligible companies are currently able to attract VC backing without giving away a majority stake, and therefore it is not necessary to expand the role of VC.

The Small Technology Coalition (SBTC) also makes the argument that large companies have set up VC funds as a means of investing in, and ultimately buying promising new companies that develop breakthrough technologies. They argue that if the Federal government funded small businesses backed by such VC funds, the SBIR program could end up subsidizing the acquisition of small businesses by big businesses.

NVCA believes that S. 2943 and H.R. 2943 address these issues by not allowing large corporations to participate in the program. To qualify for an SBIR grant, a business concern can have no more than 500 employees, including its affiliates.

Proponents for changing the current SBA rule emphasized that the biotechnology industry is unique in that it takes at least several hundred million dollars and an average of 10-15 years to develop a drug from concept through market and that biotech companies therefore must rely on venture investment as well as grant sources for sufficient funding. They also commented that by imposing unnecessary restrictions against venture capital owned small business, the SBIR program is denying talented scientists the opportunity to develop new therapies and medical technologies at an early stage, to achieve sufficient proof of principle so that venture capitalists will be willing to invest in them. They also argued that a prohibition against venture capital owned companies is stifling innovation by lowering the number of applicants and making the

SBIR program less competitive. Finally, proponents argued that the prohibition is also impeding the ability of the National Institutes of Health (NIH), which provide most of the SBIR grants received by biotech companies, to accomplish their mission of improving the health and medical care of American people.

Dr. Elais Zerhouni, Director, NIH, recently sent a letter to the SBA asking to expand SBIR funding to biotech firms that are majority owned by venture capitalist, noting that the current rule “disqualifies many highly deserving entities.”

Next Steps

The Senate Small Business Committee has indicated that they plan to hold a hearing on this issue in September. NVCA continues to work with the House and Senate and BIO to increase support for the legislation to help ensure passage. However, at this point, the timing on any Congressional movement of the legislation is unclear.