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TechNotes # 7

SBIC TechNotes

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GUIDELINES CONCERNING ALLOWABLE MANAGEMENT EXPENSES FOR LEVERAGED SBICS

The purpose of this TechNote is to describe SBA's practice in approving an SBIC's 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 obviously an important consideration in this regard, and management fees are typically the most important expense category.

Under current regulations, SBA's approval is required for your management expenses at the time of licensing (§107.140) as well as for any subsequent increases (§107.520). In July, 1997, we issued a memorandum from the Associate Administrator for Investment stating that "during the first five years of operations, management expenses of up to 2.5 percent of the combination of Regulatory Capital and an assumed two tiers of leverage based on Regulatory Capital, plus an additional \$125,000 if the sum is less than \$20 million, would generally be acceptable." Thereafter, 2.5 percent of Combined Capital should generally be used, with an additional \$125,000 if Combined Capital is less than \$20 million. A subsequent memorandum in October 2000 reaffirmed this position and clarified that the calculation during the first five years is to be based upon the Regulatory Capital determined at the time the payment is made.

A number of SBIC managers have expressed an objection to our current practice of basing the fees on the Regulatory Capital when the fee is paid since this could result in a significant reduction in allowable fees should early distributions reduce Regulatory Capital. This could occur even though the fund was still in an active investment mode, which could make it difficult for the SBIC to retain the management needed to complete its investment plan

After surveying current private industry practice we have decided to permit SBICs during the first five years to add back to the base for calculating management fees any reductions in Regulatory Capital resulting from permitted distributions. Essentially, we will use the same approach as was adopted for the investment overline limits in Regulation §107.740. In other words, we would expect to approve a request for management fees for the first five years on a base not exceeding three times the sum of:

- (a) Regulatory Capital at the time the fee is paid or begins to accrue (whichever is earlier),
- (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.

As before, an additional \$125,000 would be allowed if the sum on which the fee is based is less than \$20 million.

It must be emphasized that nothing in this TechNote 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).

There are several other considerations in SBA's approval of management expenses that should be noted:

- (1) The first five years of operations commences when a management fee based upon assumed leverage is first paid or begins to accrue (whichever is earlier), even if this occurs before the SBIC is licensed.
- (2) If an SBIC's business plan contemplates the use of less than the assumed two tiers of leverage, the allowable management expense would be correspondingly reduced.
- (3) After the first five years, if an SBIC has repaid all of its SBA leverage but still has Earmarked Assets, the base for calculating the fee is the greater of Regulatory Capital or the SBIC's investment portfolio at cost less any net unrealized depreciation.
- (4) Where management fees are being prepaid by the SBIC, the period covered should not exceed three months.
- (5) The effect of increases in Regulatory Capital on management fees should be recognized no earlier than the fiscal quarter in which the SBIC notifies SBA of the increase. Such increases cannot be applied retroactively.
- (6) 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.
- (7) All fees described under § 107.860 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.
- (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.

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