

## SBTC BACKGROUND PAPER - June 29, 2012

**SUBJECT: SBA Proposed Size & Eligibility Regulations – SBIR and STTR Programs – Federal Register Notice Vol. 77, No 94, May 15, 2012**

### Introduction

The Small Business Technology Council (SBTC) has a number of concerns with the SBA Size regulations for SBIR/STTR that were published in the Federal Register on May 15, 2012.

By Congressional directive, SBA is to determine the conditions under which small business concerns that are majority-owned by venture capital operating companies, hedge funds, or private equity firms may be eligible to participate in the SBIR program.

The major concern of SBTC is that SBA's proposal goes well beyond Congress' intent. Loopholes exist in the proposal can be used to open up the SBIR/STTR program to business concerns not contemplated by Congress – namely foreign owned companies and even large companies. These rules go beyond the 15-25% that the law permits to go to venture capital related firms. These rules apply to the other 75-85% of the SBIR program. These changes dramatically expand eligibility by allowing foreign and even large businesses into the SBIR Program for the first time.

In evaluating the SBA's rules it is important to keep in mind that, as stated in the Background preamble to the proposals, "The statutory purpose of the SBIR Program is to stimulate technological innovation by strengthening the role of innovative small business concerns in Federally-funded research and development." Further, "The purpose of the STTR program is to stimulate a partnership of ideas and technologies between innovative small business concerns and research institutions."

The SBIR/STTR programs are the most successful R&D programs in the world. 25% of the key innovations come from this small 2 1/2-3% of federal extramural expenditures. The SBIR/STTR programs have been copied in over a dozen countries. Historically their purpose is to involve small businesses in the R&D effort of the Federal Government, maximizing the government's investment in innovations by American small businesses, emphasis on "*American*" and on "*small businesses*".

This emphasis on *American* small business is the bedrock of the provisions in the Small Business Reauthorization Act of 2011 that deal with preserving and

**maintaining “...the integrity of the SBIR program as a program for small business concerns in the United States by prohibiting large businesses or large entities or foreign-owned entities from participation in the program...”**  
[emphasis added]

Thus, while encouraging more involvement of venture capital, etc. in small businesses, while preserving their eligibility for the SBIR program, SBA’s mandate from Congress nevertheless is to issue regulations that ensure that large businesses or large entities or foreign-owned entities *cannot* participate in the SBIR program. (Sec. 5107 (c) (3) (ii))

The SBTC contends that the proposed regulations do not provide this assurance.

## THE ISSUES

### FOREIGN OWNERSHIP

- a. The proposed rules, while not explicitly saying so, will in effect allow foreign owned companies to compete for SBIR/STTR grants.
- b. Rather than adopting the term “small business concern” used throughout the Reauthorization Act, SBA proposes to use the term “domestic business concern”, which does not contain a definition of “domestic” that would foreclose eligibility of firms that are foreign owned.
- a. SBA’s proposal does not include any provision as to how it will determine with some degree of accuracy if venture capital firms, etc. are foreign-owned or American-owned.

### AFFILIATION RULES

The proposed rules eliminate affiliation tests for large minority shareholders, an exception made for the SBIR program only. This expands eligibility to firms that are not eligible for other SBA programs. Why?

Existing rules are designed to determine if an applicant is indeed a small business. SBA’s proposal changes the rules’ focus from stock ownership, currently used to determine affiliation, to the location where a company chooses to file incorporation papers without regard to identifying actual ownership, making it virtually impossible to determine if concerns majority owned by venture capital companies, etc. are in fact small businesses.

### DOMESTIC BUSINESS CONCERNS

SBA has proposed a definition of “domestic business concerns” that has no requirement that these new entrants into the SBIR/STTR program be in fact

“domestic,” meaning U.S. owned. SBA proposes only that the concern “...has a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S. economy through the payment of taxes, or use of American products, materials or labor.” SBA further adds that the concern must be “...created or organized in the United States, or under the law of the United States or of any State.” Purportedly this is intended to further define “domestic.”

Instead of focusing on ownership, SBA proposes to use the above definition in which the only test is where a company chooses to file its incorporation papers. Any foreign company or individual can go on the Internet and file incorporation papers and, by doing so, meet the new standard that it be “organized in the United States.”

This change is a radical departure from the current ownership requirement that to be SBIR eligible the company must be 50+% owned by US citizens. SBA offers no explanation for the departure even though the Reauthorization Act suggests that its criteria should include whether an applicant is at least 51 percent owned or controlled by citizens of the U.S. and whether an applicant is domiciled in the U.S.

Particularly troubling is the fact that this new proposal affords the US taxpayer little assurance that the technology will create US jobs and help the US economy. Without appropriate safeguards against foreign ownership, this definition opens up hundreds of millions of SBIR/STTR dollars to companies that are foreign owned, companies that could take the technology paid for by US taxpayers to other countries for commercialization and job creation and thus fail to support U.S. interests. *This is indefensible.*

This definition contains loopholes that would allow otherwise *ineligible* entities seeking entry to the SBIR program to do so successfully. It is ambiguous at best and questionable that it carries out the intent of the SBIR program that it be a program for “small business concerns in the United States.”

#### VENTURE CAPITAL OWNERSHIP

SBA’s definitions are deficient in identifying how it will determine if a venture capital company is foreign owned. Venture capital firms incorporated in the U.S. could have investor groups that are foreign owned. In fact, they could be solely owned by a single foreign investor or a group of investors without any American ownership. Yet there is no provision in SBA’s proposed regulations requiring VCs to disclose the ownership of its investor groups.

This has significant national security implications.

To illustrate: Countries that are our adversaries could use the SBA rules to seek information on mission-critical technology development for defense and other US Government applications by forming entities that invest in, or create, US-based companies for the purpose of winning SBIR grants and thus gather information that the Department of Defense would not want them to have. Many SBIR programs are even classified and firms winning such awards take precautions against non-citizens working on the projects except under special circumstances and extreme surveillance.

And high quality jobs created would flow to serve foreign interests and the interests of foreign owners, not the U.S. economy.

SBA needs to understand and deal with this issue because this would affect about half of the nationwide SBIR programs. There is no reason why VC funds that participate in SBIR under the new rules should not be required to do a US percentage calculation to determine if the SBIR applicant is foreign owned or controlled.

#### AFFILIATION RULES

The rules that are being proposed for SBIR/STTR programs to measure whether a firm's affiliation with other entities preserve an applicant's status as a small business shift the focus away from an "ownership" standard to "who controls the board of directors."

This is a loophole that would allow large firms which are affiliated with an SBIR applicant to participate in the SBIR program simply because they did not control the applicant's board. Under existing SBA affiliation standards, this would not occur.

Without explanation, SBA appears to be ignoring its long history in developing and refining its affiliation measures with this proposed change, a change which may have the unintended consequence of allowing large entities to control small concerns. For example, one firm or even two firms that have only have 49% interest each in an applicant's firm would be eligible to participate in the SBIR/STTR program because neither controlled the board. Shifting away from an "ownership" standard opens up the program to large firms.

Finally, this change in the affiliation rules is only being applied to the SBIR/STTR program and not to SBA overall. SBA is very clear on this point. "...SBA has amended those principles [size and affiliation] solely for purposes of the SBIR and STTR program." SBA goes on to say that "...where an SBIR or STTR applicant's voting stock is widely held or two or more persons hold

large block of voting stock but no one person owns more than 50 of the stock, then the board of directors controls the applicant.”

Although SBA is soliciting comments on alternatives to this proposal, SBTC recommends that SBA should continue to apply its current affiliation provisions to the SBIR/STTR programs. SBIR/STTR firms are familiar with them and no rationale has been offered to support the change.

## CONCLUSION

SBA’s proposal is a radical departure from the current ownership requirement that to be SBIR eligible the company must be 50+% owned by U. S. citizens. Worse, in abandoning this requirement, SBA’s proposals built in no safeguards to avoid opening up competition for SBIR/STTR grants to foreign owned entities and permitting the dispensing of Federal tax dollars, along with jobs, to entities outside the U.S. The SBIR/STTR programs have for more than 25 years been designed to encourage small businesses participation in Federal R&D programs, build the domestic economy, foster growth and innovation within the U.S and advance U.S. public interests. SBA’s current proposals will significantly alter the purpose of the SBIR/STTR programs and thwart Congress’ intent to ensure the involvement of innovative U. S. small businesses in Federal research.