



HAZIC INVESTMENTS

## BEST PRACTICES AND KEY CONSIDERATIONS FOR FIRMS WITH SBIC LICENSES AND THOSE PLANNING TO LAUNCH AN SBIC FUND

### For SBICs, Readiness Is Everything

It's Monday morning, and the CFO of an investment firm walks into his office to find an SBA examination notice on his desk. If his team has done their jobs, the exam data should be collected and the request list information and schedules should be ready to go. If they haven't, this is the beginning of a very long, challenging week. Which will it be?

#### **SBICs: REWARDS AND CHALLENGES**

SBICs are a highly attractive private equity investment option, enabling GPs to access government leverage at low rates that enhance returns.

But they also come with more complex administrative requirements, and those requirements are changing all the time. Firms that sign up for the SBIC program must be prepared to keep pace with those changes, as the consequences for a failure to comply are significant.

Whether you are considering the launch of an SBIC or have already launched one, this white paper will help you determine whether you are ready to handle the additional administrative demands and maximize the benefits of this fund strategy.

#### **COMPLEX ADMINISTRATION**

SBICs—especially those that are leveraged—involve rigorous reporting requirements and tight deadlines. General Partners with SBIC funds must collect and submit at least three times the amount of data in half the amount of time. With this extra layer of added complexity, the back office must be ready to take on a heavier task load related to compliance and reporting. Without the right processes in place, the potential for compliance failure and the resulting consequences is high.

**Financial statements** Preparing financial statements for an SBIC requires significantly more work. An SBIC must submit unaudited quarterly financial statements along with audited annual statements in SBA's required format while adhering to SBA's valuation guidelines and systems.

Additional fund data that must be collected and reported to SBA includes:

- Smaller investments
- Portfolio company financials
- Portfolio company tax returns
- Holding company information
- Portfolio company management information and equity ownership
- Non-cash income information
- Cash receipts from the portfolio company
- LMI investments
- Overline calculations for investment diversification requirements
- Cost of money compliance tests
- Security information (including debt vs. loan and GAAP vs. SBA valuations)

**Compliance exam** Firms that manage leveraged SBICs must also undergo an annual compliance exam and prepare additional forms in accordance with SBA requirements. Examiners have the authority to obtain and review a wide range of records, including SBA agency records, licensee records (including books and the working papers of the firm's independent public accountant), and records of portfolio companies.

For back offices and fund administrators that are experienced and prepared, a compliance exam is simply part of the administrative process. For those that are new to the program, the prospect can be intimidating, and the risk of making errors is higher. Some of the most common exam issues include:

- Filing 1031s late
- Failing to answer questions about investment compliance
- Incorrectly filling out deal documents
- Incorrectly allocating fees for co-investments
- Incorrectly recording high-level expenses
- Incorrectly recording fee reimbursements

**General Partners with SBIC funds must collect and submit at least three times the amount of data in half the amount of time.**

## Understanding the Stakes

Whether you choose to outsource SBIC fund administration to a third party or perform it in house, it's important to know and apply best practices right from the start.

Every GP with an SBIC has to sign up for governance by SBA, a regulator with a long history and significant power. If an issue arises, SBA remedies can range from assessing fines to limiting or shutting off access to leverage, which effectively puts two-thirds of the fund's capital on hold. While the more extreme option is applied by SBA reluctantly (because it can hurt the fund, the portfolio companies, and the investors), fines are becoming more frequent.

More common are requests for additional information. When the information submitted is inconsistent or incomplete, SBA may make more frequent, ad hoc requests that eat into your back-office resources and increase your operating costs. This also puts you in SBA's crosshairs.

When SBA exerts these powers, it's seldom caused by a firm intentionally circumventing the regulations. Most often, it's a lack of awareness on the part of a GP that lacks experience in this type of fund strategy. It's easy for new SBICs to overlook a specific requirement or miss a reporting deadline. Firms that are new to SBICs may also take too much time in resolving an issue after being notified, and that can trigger even greater scrutiny and mistrust on the part of SBA.

Administrative issues can also impact investor relations. Investors may not wield as much power as SBA, but they are becoming savvier when it comes to understanding their options and their legal rights, and they will not tolerate a lack of transparency or a lack of compliance. If the GP does not meet the requirements of the Limited Partner Agreement, they may resort to legal action or even have the GP removed if the situation is considered to put their holdings at significant risk.

## Preparing for Success

Successfully administering an SBIC is a proactive effort, not a remedial one. By the time a report deadline is missed or a submitted report is discovered to contain errors, it's too late. At that point, your reputation with the regulator—and perhaps even with your investors—is on the line, and you may be facing disciplinary action.

Over the past 15 years, PEF Services has administered over 100 SBIC funds spanning 70+ General Partner clients. Along the way, we have identified the four key factors that ensure success in this challenging reporting environment.

“With an SBIC, being trained, prepared, and informed is essential. People can get creative and innovative on the investment side, but nobody is rewarded for ‘creative compliance.’”

### **ANNE ANQUILLARE, CEO & PRESIDENT, PEF SERVICES**

**Training.** If you plan to keep fund administration in house, invest in SBA training for relevant staff. It's an essential first step to ensuring compliance, yet many firms don't do it. Keep in mind that SBIC training is not a “one and done” proposition. The program is always changing, and staying abreast of those changes requires a commitment to ongoing training. It's also important to stay informed of changes in the regulations as well as updates found on the SBA website.

SBA training provides a foundational knowledge, but it's also important to commit to continuous learning through webinars, seminars, and other industry events. Attendance at these events acts as an “early warning system,” ensuring that when changes happen, you are the first to hear about them.

In addition to training back office staff, you should also use a “train the trainer” approach to ensure that the wider team understands the requirements. Have your in-house expert train the deal and compliance personnel at your firm, including those at the top who have a fiduciary responsibility to SBA and your investors.

By training your staff and having them train others on your team, you can ensure that they understand the obligations and are prepared to meet them.

### **As of 2016, the SBIC Program has...**

**DEPLOYED \$67+ BILLION OF CAPITAL | MADE 166,000+ INVESTMENTS IN SMALL BUSINESS | LICENSED 2,100+ FUNDS<sup>1</sup>**

<sup>1</sup> US Small Business Administration Office of Investment and Innovation, SBIC Overview 2016.

If you plan to outsource fund administration, ensure that your service provider maintains a fully trained staff. At PEF, for example, all of our client-services staff complete SBA training through SBA's class, industry events, and extensive in-house training.

**Industry participation.** While SBA regulators don't hand out seals of approval, they do pay close attention to the knowledge and experience levels of the firms they work with—General Partners, legal and audit firms, and fund administrators. If they know that the people who are submitting the reports are knowledgeable, responsible, and experienced, that inspires their confidence and makes life easier.

One of the ways in which you can demonstrate your commitment is to increase your levels of industry involvement. If you administer the fund in house, get your team on an industry task force, ensure that they dedicate time to speak to the regulator one on one, and make sure they attend industry events and conferences. By increasing their involvement in industry events, they are building valuable relationships, establishing credibility, and boosting levels of confidence among both regulators and investors.

If you plan to outsource your fund administration, make industry participation part of your selection and evaluation criteria, and find out what each firm does to stay connected and involved.

***One of the ways in which you can demonstrate your commitment is to increase your levels of industry involvement***

**Technology.** Collecting fund data ad hoc using spreadsheets is a risky practice for any fund strategy, but the accelerated reporting timeframe and the amount of data required for SBICs drive that risk even higher.

The majority of spreadsheets—an estimated 88 percent—contain errors.<sup>2</sup> Investing in a robust accounting system with a centralized database for collecting fund data helps your firm to avoid these risks and enhance performance efficiency.

<sup>2</sup> Journal of End User Computing, “What We Know About Spreadsheet Error,” 2008.

In addition to streamlining the collection and processing of massive amounts of data, the platform should also support the creation of customized reports. Without a system that enables you to “slice and dice” the data to build different reports, your administrative team will spend inordinate amounts of time compiling the data for each group using spreadsheets, and every time the data is copied and pasted or exported from one place to another, the risk of errors increases.

Accounting systems customized for illiquid alternative asset fund strategies, such as Investran, eFront, and AltaReturn, are sophisticated and reliable, but be aware that they do not collect and track the types of data SBA requires. To meet SBIC reporting requirements, you will either need to develop your own customized software solution or select a fund administrator whose services are supported by a specialized platform.

Processes and certification. If you plan to outsource SBIC fund administration to a third party, **System and Organization Controls (SOC) 1, Type 2 certification** is a must. This certification process, which must be renewed annually, includes a rigorous audit of the processes, systems, and internal controls used to administer the fund and an evaluation of those controls to ensure that they are designed to achieve the control objectives and that they operate effectively.

## **Investran, eFront, and AltaReturn are sophisticated and reliable, but be aware that they do not collect and track the types of data SBA requires.**

As part of the process, auditors need to perform a risk assessment on the transaction and technology controls used to administer the SBIC to determine how they compare to industry standards. This assessment examines the processes for setting up wires and booking journal entries, including the in-house software and controls associated with these processes. Auditors also review the separation of duties, passwords, and the approval process.

**From an auditor’s perspective:** If the Administrator has a favorable SOC 1, Type 2 audit completed, there is a comfort level associated with it because the auditors know their controls have been tested and have been approved. If the team has an unfavorable SOC 1 or has not been certified, the auditor will need to perform additional testing to measure the level of risk. This could include additional on-site visits and testing that can add 15 to 20 hours or more, as well as added costs to the audit process.

**From an investor’s perspective:** Investors prefer that a fund administrator obtain and maintain SOC 1 certification. This is an item on most investors’ DDQ lists because it provides assurances to investors, both current and prospective, that the investment firm provides excellence in operational processes and controls and takes their responsibility to investors seriously.

Whether you choose to administer an SBIC in house or outsource the function, auditors will apply the same standards during their review. Ultimately, your firm is liable for all the information, processes, and security completed on behalf of the fund.

## **Best Practices for SBIC Administration**

**Drawing on more than 50 years of collective involvement in the SBIC program, PEF’s SBIC administration experts recommend these best practices to strengthen the process and ensure compliance.**

**Capture data up front.** To stay on top of SBA’s extensive data requirements for reporting and compliance, make a point of collecting all the investment data up front and storing it in a centralized database. That way, the data is ready to go and can be used for the required report with minimal effort. Given that SBA provides only a 30-day window for quarterly reporting, having to collect fresh data during that period puts your firm at risk of missing the deadline or making a costly error.

**Communicate proactively.** Take full advantage of the opportunities for leverage draws by setting up a communication schedule that alerts the deal team ahead of time so that they have time to discuss and request any funds required. Many firms operate with a “fire drill” mentality, where communication happens at the last minute and decisions are made in haste. By building in a proactive communication process, you can put the right information in front of the right people at the right time.

**Build in multiple reviews.** It’s easy to overlook your own mistakes, and the closer you are to the work, the more likely you are to become blind to those errors. This is why PEF adheres to a strict review process that ensures that two—and sometimes three—pairs of eyes examine every report that goes out to investors, regulators, and auditors. Build adequate time and human resources into your review process to support this multi-level review process, and we guarantee you will find and eliminate substantive errors virtually every time.

**Plan for change.** Changes such as staff turnover or the launch of a new fund can place significant stress on the back office. Be proactive and prepared with a redundancy plan that distributes knowledge and responsibilities across the team so that business continuity and productivity are minimally disrupted by team changes. It’s a good idea to plan for growth, too; if your firm plans to add another SBIC fund, start stress testing your processes now.

## SHOULD YOU ADMINISTER IN HOUSE OR OUTSOURCE?

There are no hard-and-fast rules when it comes to outsourcing the administration of an SBIC. An in-house team with the right resources and commitment level can do an excellent job of self-administering.

However, when making the decision, it’s worth asking this question: “Does our firm have both the **expertise** and the **budget** to do the job well?”

SBIC fund administration is complicated, and requires the close oversight and involvement of someone with senior-level accounting expertise and a specialized knowledge of SBIC requirements and regulations. If you have no one on staff with this type of background who can step up and take ownership, you may wish to enlist a third-party fund administrator with expertise in this area.

In-house SBIC fund administration is also resource intensive, and for smaller firms, it may simply not be a feasible option. Regardless of size, even for a skilled and experienced back-office team, a lack of resources can create ongoing issues. Often, the back office may simply not have the budget to comfortably manage the complexity and intensity of SBIC reporting.

Remember that you will need to factor in:

- SBA training
- Annual conference attendance
- Additional reporting requirements
- An investment in additional technology
- Redundancy and potentiality scalability

For smaller firms, a third-party fund administrator with an SBIC specialty may be a more cost-effective solution. A fund administrator will be able to provide the expertise, network, and technology infrastructure required to manage your specialty fund, while the costs of maintaining these resources are kept low because they are distributed across a pool of clients. For more information on evaluating in-house and outsourced options, read “Fund Administration Outsourcing: A Guide to Evaluating the Options and Making the Right Decision.” ([www.pefservices.com/Outsourcing-WP](http://www.pefservices.com/Outsourcing-WP))

## ALLOCATING FUND ADMINISTRATION EXPENSES

How should an SBIC allocate fund administration expenses? The rules are about to change. Recently, SBA issued a draft of TechNote\* 7b, which, along with SBA’s 2016 Model Limited Partnership Agreement (LPA), will have a significant impact on leveraged SBIC expenses, including the allocation of fund administration expenses.

Previously, SBICs were only required to pay for an SBIC fund’s “bookkeeping” portion of third-party fund administration out of the management company. Following the new LPA and the finalization of TechNote 7b, leveraged SBICs are required to pay the following expenses from the management company (with certain exceptions):

- 1. Bookkeeping and similar services**
- 2. Accounting fees**
- 3. Preparation of annual and in financial statements of the Partnership, portfolio financing reports, and capital certificates**

New SBICs should take special care in reviewing SBA’s Model LPA, regulations, and guidance when drafting their own LPAs with regard to other services provided by third-party fund administrators. Expense policies aside, when it comes to determining business decisions for an investment fund, where the expense falls shouldn’t be the primary driver. The business needs and goals should drive the decision, the governing documents should drive the location of the expense, and both should be transparent to investors and regulators.

\*SBA issues TechNotes to provide additional guidance on regulations. Sign up for updates and TechNotes [here](#).

## CHOOSING A FUND ADMINISTRATOR FOR YOUR SBIC

While price is a factor, and the easiest one to compare, using it to select a crucial vendor for your firm is never a good idea. And when your fund is an SBIC, it’s even more important to prioritize other factors when selecting your fund administration solution. Your objective should be to find a service partner with the people, processes, technologies, and specialized experience required to meet rigorous administrative requirements and protect your firm’s reputation and investor relationships.

Look for a fund administrator that offers:

- System and Organization Controls (SOC) 1, Type 2 certification
- A strong reputation in the SBIC community
- An active list of clients with SBIC funds
- A minimum of 10 years in SBIC fund administration
- A documented service-level agreement (SLA)
- A documented onboarding process
- A documented disaster recovery and business continuity process
- Investor reporting processes that follow ILPA guidelines
- An integrated accounting, analytics, and reporting platform
- An investor portal that provides 24/7 digital access to reports
- A CFO portal that provides access to fund data and analytics

For more information on selecting the right fund administrator, read “[Making the Switch: Why General Partners Are Rethinking Their Needs and Replacing Their Fund Administrators.](#)”

## NEXT STEPS

While SBICs require more reporting and compliance, they are a rewarding and advantageous fund strategy that many General Partners have used to strengthen lower and middle market America and generate great returns for their investors. The key to success is to plan ahead and ensure that your firm has access to the essential capabilities and resources required to support the administration of this type of fund. Whether you choose to administer your fund in house or partner with a third-party fund administrator, the core success factors are the same: clear, documented processes based on best practices, leading technologies, and an ongoing commitment to industry training and networking.

## ADDITIONAL RESOURCES

**FOR UPDATES ON SBIC ADMINISTRATION, READ:**

**Changes to SBIC Licensing and Examination Fees** ([pefservices.com/changes-to-sbic-licensing-and-examination-fees](https://pefservices.com/changes-to-sbic-licensing-and-examination-fees))

**SBA Update on SBIC Program Examination Priorities** ([pefservices.com/sba-update-on-sbic-program-examination-priorities](https://pefservices.com/sba-update-on-sbic-program-examination-priorities))

**SBA Replaces the Final Rule Concerning SBIC Investments in Passive Businesses** ([pefservices.com/sba-replaces-final-rule-concerning-sbic-investments-passive-businesses](https://pefservices.com/sba-replaces-final-rule-concerning-sbic-investments-passive-businesses))

***FOR ADVOCACY AND TRAINING RESOURCES, VISIT:***

**The SBIA** ([sbia.org](http://sbia.org))

**SBA Learning Center** ([sba.gov/tools/sba-learning-center/search/training](http://sba.gov/tools/sba-learning-center/search/training))

***FOR LEGAL AND EDUCATIONAL RESOURCES, VISIT:***

**CohnReznick** ([cohnreznick.com/industries/financial-sponsors-and-financial-services/sbics](http://cohnreznick.com/industries/financial-sponsors-and-financial-services/sbics))

**Eversheds Sutherland** ([us.eversheds-sutherland.com/PracticesIndustries/Capital-Markets-Investments/Small-Business-Investment-Companies-SBICs](http://us.eversheds-sutherland.com/PracticesIndustries/Capital-Markets-Investments/Small-Business-Investment-Companies-SBICs))

**Foley Hoag LLP** ([foleyhoag.com/practices/business/sbic](http://foleyhoag.com/practices/business/sbic))

**Locke Lord LLP** ([sbiclaw.com](http://sbiclaw.com))

**McGuire Woods** ([mcguirewoods.com/Services/Industries/Private-Equity/Small-Business-Investment-Companies](http://mcguirewoods.com/Services/Industries/Private-Equity/Small-Business-Investment-Companies))

**Pepper Hamilton LLP** ([pepperlaw.com/capabilities/small-business-investment-company-sbic-practice](http://pepperlaw.com/capabilities/small-business-investment-company-sbic-practice))

**RSM** ([rsmus.com/what-we-do/industries/financial-services/asset-management/small-business-investment-company.html](http://rsmus.com/what-we-do/industries/financial-services/asset-management/small-business-investment-company.html))