SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

February 13, 2012

Delivered via E-Mail

Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds And Private Equity Funds

Re: (OCC) Docket No. OCC-2011-0014 and RIN: 1557-AD44;
(Fed) Docket No. R-1432 and RIN: 7100-AD82;
(FDIC) RIN: 3064-AD85;
(SEC) Release No. 34-65545; File No. S7-41-11 and RIN: 3255-AL07

Specific Questions Addressed:
Q. 276
Q. 277
Q. 278
Q. 280
Q. 310
Q. 378

Small Business Investment Companies (*SBICs*) are small, highly regulated private investment funds, licensed and overseen by the U.S. Small Business Administration (*SBA*), that invest capital exclusively in domestic small businesses. We are the Small Business Investor Alliance (*the Alliance*), the trade association that represents the SBIC community, both fund managers and investors in SBIC funds. The Alliance represents the vast majority of SBIC funds, both mezzanine or private equity funds, all of which focus on small business, making debt and equity investments generally in the $1 to $15 million range. The vast majority of Alliance member funds manage at least one active SBIC. The total assets under management by such funds is $9.4 billion and the average number of assets under management (per fund) is $59.9 million. The Alliance's membership is geographically diverse with approximately 40% in the Northeast, 32% in the Southeast, 23% in the Midwest, and the remaining amount elsewhere in the U.S.

We welcome the opportunity to comment on the Volcker Rule (sometimes, Proposed Rule). We also are available to provide technical assistance to the agencies upon request and to provide data with respect to SBIC matters. Our perspective on this Proposed Rule is greatly influenced by the recent legislative actions[1] of Congress, which has been quite clear in its intent to support the ongoing support of small business growth via SBICs. Moreover, the Congress has expressly indicated in the Dodd-Frank Act (*DFA*) that SBICs should be exempted from the investment limitations of the Volcker Rule.

By way of background, the purpose of the SBIC program is to increase the amount of capital available to small businesses. Since the passage of the Small Business Investment Act of 1958 (15 U.S.C. §681, et. seq.), SBICs have bridged the gap between entrepreneurs' need for capital and traditional financing sources and have provided more than $60 billion to over 109,000 job-creating small businesses that would otherwise lack the access to capital.[2] SBICs commonly invest in companies "off the beaten path" and usually invest in companies that do not qualify for financing from large financial entities. SBICs have provided capital to many small businesses at critical moments in their early development, assisting in their growth to become major employers. Such businesses include: Intel, Apple Computer, Callaway Golf, Whole Foods Market, Staples, Federal Express, Costco, and Quiznos.

To become licensed as an SBIC, private funds raise private capital from individuals, institutional and other entity investors, increasingly commercial banks, and go through a rigorous application process with the SBA. In recent years, the amount of private capital raised by a fund has been given additional weight in SBA's licensing decision. SBICs can be licensed as either leveraged (***Debenture SBICs***) or non-leveraged funds (often bank sponsored). A Debenture SBIC can access low cost government funds in an amount equal to twice the SBA's private capital, thereby tripling the pool of capital available for small business investment. No SBIC, however, may have outstanding more than $150 million of debenture leverage from the SBA and no group of affiliated SBICs may have outstanding in the aggregate more than $225 million of debenture leverage. These maximums are set by statute. Consequently, for every dollar of private capital held by an SBIC, such as capital invested by a bank, two dollars of SBA leverage (up to the statutory maximums) can be added, which aggregate amount can then be invested in American small businesses. Leverage cannot be obtained by an SBIC if the fund is out of regulatory compliance or is in a weakened condition. It is common for a bank, or a host of banks, to provide capital to Debenture SBICs.

Non-leveraged SBICs do not have access to SBA debentures and have in the past often been the type of fund sponsored by banks. A review of the recent history of SBICs shows that, in FY2011, there were 19 bank-owned Debenture SBICs compared to 27 non-leveraged SBICs.[3] That approximately 59% of the total number of bank-owned SBICs are fully-sponsored and organized by banks, even though such SBICs do not rely on access to SBA leverage, speaks to the benefit to a bank of sponsoring a SBIC. Besides having a specific investment focus and providing

---

[1] See Section 403 of the Dodd-Frank Act, amending Section 203(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(b)). (Exempting advisers who solely advise SBICs from registration.)

[2] United States Small Business Administration (2011). Data Management Branch, Investment Division. SBIC Program Overview, Washington 2011. http://www.nasbic.org/?page=SBIC_Statistics.

[3] Id.

consistent returns, banks sponsor and own SBICs for a variety of reasons, including the ability to receive Community Reinvestment Act (*CRA*) credit for investing in SBICs.

Funds licensed as SBICs serve a statutorily mandated public policy purpose to improve and stimulate the national economy by investing in the small business segment of the national economy. The SBIC program supports and stimulates the flow of private equity capital and long-term loan funds to small business concerns by financing their business operations and their growth, expansion and modernization - which financings, even as supplemented by SBICs, remain inadequate to meet small business needs. In our view, it is appropriate and consistent with the Dodd Frank statute to place highly regulated SBICs with a defined social benefit into a different category under the Proposed Rule than other investment entities that lack a similar public policy purpose and which are prohibited or restricted from receiving bank investment under the Proposed Rule. Moreover, as can be demonstrated by their track record, SBICs do not pose systemic risk or significant risk to banks, but rather, provide positive returns. For instance, from Calendar Year 1998 to 2005, Debenture SBICs averaged an estimated 10.85% Internal Rate of Return (IRR) on pooled private capital.[4]

As a testament to the SBIC Program's continued ability to consistently and effectively provide capital to America's job creators, SBICs provided $1.44 billion of capital to small businesses in FY2008, which total grew to $2.59 billion in FY2011 and continues to grow.[5] It is our view that the successful track record of the SBIC Program, particularly during this unsettled economic time, motivated the Congress to support the ongoing growth of SBICs. Indeed, we believe that Congress has been quite clear in its legislative intent in several instances to support the ongoing growth of SBICs. In this instance, the Congress has expressly indicated in the DFA that SBICs should be exempted from the investment limitations of the Volcker Rule.

Below, the Alliance has responded to specific questions posed by the Proposed Rule regarding the investment and sponsorship exemptions for SBICs.

Question 276. Is the [P]roposed [R]ule's approach to implementing the SBIC, public welfare and qualified rehabilitation investment exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?

Yes, Section 13 of the Proposed Rule implementing section 13(d)(1)(E) of the Bank Holding Company Act (BHC Act) permitting a covered banking entity (or affiliate or subsidiary thereof) to acquire or retain any interest in one or more SBICs is effective to ensure the provisions of the law come to realization as evidenced by Congressional intent. We offer no comment on the public welfare or qualified rehabilitation investment exemptions as our expertise relates principally to SBICs.

[4] "Early Stage Small Business Investment Companies - Historical Impact of SBA Leverage for Standard SBICs." 2012. United States Small Business Administration. January 2012.

[5] Id.

Although we support the SBIC investment exemption as proposed, nevertheless, effective implementation can be impaired or blunted if related sections are not addressed or classified. For example, we have concerns that the Proposed Rule erroneously extends the so-called "covered transactions" prohibitions under the Volcker Rule to SBICs.

Specifically, Section 16 of the Proposed Rule should be revised to more accurately reflect the statutory language of Section 13(f) of the BHC Act. As it is currently written, Section 16 of the Proposed Rule could be read to prevent a banking entity that serves as the investment manager, investment adviser, commodity trading adviser or sponsor to an SBIC from entering into a "covered transaction," as defined in Section 23A of the Federal Reserve Act, with the SBIC. These restrictions on transactions between banking entities and certain SBICs do not appear to have a basis in the statutory text of the DFA and, in our view, run contrary to the intent of the BHCA Section.

Section 13(f) of the BHC Act imposes limitations on relationships between banking entities and hedge funds and private equity funds. It states that "[n]o banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund . . . may enter into a transaction with the fund . . . that would be a covered transaction" as defined in Section 23A of the Federal Reserve Act. Section 13(f) of the BHC Act only places the limitation on transactions between banking entities and hedge funds and private equity funds. There is no language that places these limitations on transactions between banking entities that serve as the investment manager, investment adviser, or sponsor to SBICs.

We believe that the agencies should revise Section 16 of the Proposed Rule to implement the Congressional mandate expressed in Section 13(f) of the BHC Act and clearly state that the limitations in Section 16 do not apply to transactions between covered banking entities and SBICs. Simply put, SBICs should not be included within the definition of hedge fund or private equity fund under the DFA for these purposes.

Question 277. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Yes, we believe that at least one significant revision is necessary. Specifically, as noted previously, a private fund attempting to become licensed as an SBIC by the SBA must establish that it has raised sufficient private capital, which often comes from banks, to implement the SBIC's proposed business plan.

The SBIC licensing process involves two distinct phases. An applicant first submits to SBA a preliminary application called, management assessment questions (***MAQ***). The MAQ consists of a detailed business plan for the fund and the biographical and investment track record information about the fund's management team. After an in depth review of the MAQ, SBA staff interviews the management team. It is helpful to an applicant at this stage to be in a position to indicate that investors have made preliminarily commitments to invest. If the SBA believes the business plan of the applicant and its management team are appropriate for the SBIC Program, then the SBA will authorize the applicant to file a formal license application by issuing a so-called "***green light letter***." The applicant then has eighteen months to submit its formal license filing.

The formal license application contains the legal documents governing the applicant's and its manager's operations and additional information about the management team and its track record. For a license application to be accepted for processing by the SBA, the applicant must show that it has raised a minimum of $15 million of private capital. The documents submitted to the SBA include a capital certificate signed by the applicant attesting to the amount of private capital raised and identifies the name, address and the amount committed and paid by each private investor.

As a consequence of the SBIC application process, the Alliance strongly urges that banking entities (including affiliates and subsidiaries) be permitted to invest not only in SBICs that have received their SBIC licenses, but also to invest in applicants for an SBIC license that either have received green light letters (that is permission by the SBA to file a formal SBIC license application), or have filed a SBIC license application. If the Proposed Rule is not so expanded, an applicant would not be able to receive credit from the SBA for a bank's commitment to fund an SBIC in formation. This inability to make a formal commitment to an SBIC in formation could not only prevent the application from being filed due to a lack of sufficient private funds but could also result in a license not being granted because the SBA determines that the applicant has insufficient private funds to accomplish its business purpose.

What is being requested is parallel to the language set forth in Rule 3c-2 promulgated by the Securities Exchange Commission under the Investment Company Act of 1940, as amended (***1940 Act***). That rule provides in relevant part:

> "For the purpose of Section 3(c)(1) of the Act, beneficial ownership by a company owning 10 per centum or more of the outstanding voting securities of any issuer which is a small business investment company licensed to operate under the Small Business Investment Act of 1958 **or which has received from the Small Business Administration notice to proceed to qualify for a license, which notice or license has not been revoked**, shall be deemed to be beneficial ownership by one person..." (emphasis added).

The language of this SEC rule under the 1940 Act ensures that both a licensed SBIC and one with authorization from the SBA to proceed to apply for a license can benefit from the special investing rules so as to qualify for exemption from the requirement to register as an investment company under the 1940 Act. The Alliance urges that the Volcker Rule adopt parallel or comparable language.

In making this recommendation, the Alliance is mindful that certain applicants that have been authorized to file a formal license do not file the license, or after filing a license application, do not receive a license. On the other hand, in the range of 90% of all SBIC license applicants whose applications are accepted for processing receive SBIC licenses. The Alliance wishes to assure the agencies involved that if an applicant does not receive its license, the fund's investment documents can provide for the withdrawal of a bank investor, the return of any capital drawn from the bank investor and the termination of all obligations of the bank investor. In fact, a number of SBIC applicants have so provided such standard conditions in their investment documents.

The Alliance believes that the expansion it is suggesting is fully consistent with the Congressional intent of permitting bank investments in SBICs and supporting and expanding the SBIC program.

Question 278. Should the [P]roposed [R]ule permit a banking entity to sponsor an SBIC and other identified public interest investments? Why or why not? Does the Agencies' determination under section 13(d)(1)(J) of the BHC Act regarding sponsoring of an SBIC, public welfare or qualified rehabilitation investment effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?

Yes, banks should be permitted to organize and sponsor SBICs. Even under Glass-Steagall, SBIC investments were permitted while other investments were not. Historically, banks have been explicitly permitted to organize, sponsor and invest in SBICs[6]. The DFA recognized that the SBIC program promotes significant social benefits, not the least of which is new job creation, without creating systemic risk for banks or the national economy, and the DFA was drafted explicitly to encourage continued participation by banks with SBICs. As the agencies tasked with implementing the provisions of the Volcker Rule move forward with the process, it is important to ensure that a full SBIC exemption for investment, sponsorship, and operation by banks, consistent with the operation of the SBIC program, is implemented. Again, we confine our comments to the SBIC issues only.

Sponsorship by banks of SBICs will strengthen the SBIC program. This strengthening will result in more funds being made to U.S. small businesses to assist in their growth and help create jobs. Bank sponsorship is also likely to encourage the participation of other institutional investors in the SBIC Program. In addition, bank sponsorship of SBICs often has different characteristics than bank sponsorship of other investment funds, such as a hedge fund. If a bank sponsors an SBIC, the bank's capital commitment is more than seed capital to start the fund. By contrast, seed capital in non-SBIC bank sponsored funds is often subsequently returned to the bank after other private investors are admitted. Again, by contrast to non-SBIC funds, a bank sponsor of an SBIC will admit additional investors and seek debenture leverage from the SBA as well as make a capital commitment which remains in the fund and is drawn *pari passu* with the capital commitments of other private investors. In fact, the SBA does not permit an investor to withdraw from an SBIC or terminate its capital commitment, except under special circumstances applied to regulated entities or an approved transfer of interest. These requirements pertaining to the SBA program contribute to the stability of the small business investment involved and, by extension, contributes to the financial stability of the United States.

[6] See Data on SBIC Program, Bank-Owned SBIC Licensees FY1993 to 2011, Attachment 1 to this letter.

Question 280. Does the [P]roposed [R]ule unduly constrain a banking entity's ability to meet the convenience and needs of the community through CRA or other public welfare investments or services? If so, why and how could the Proposed Rule be revised to address this concern?

In contrast to the wording of this question, the Proposed Rule encourages and supports a bank's ability to meet the needs of the community as defined by the CRA. In the Interagency Questions and Answers released in March 2010, the most recent guidance put forth on the CRA, SBICs are explicitly listed as an example of a CRA "Qualified Investment," and are also explicitly cited as meeting a "purpose" and "size" test used to determine if a bank's investment promotes community development. Given this, a full exemption to permit continued bank investment into SBICs will only increase the opportunities a bank will have to fulfill its role as defined by the CRA.

It is also noteworthy that we understand that the Office of the Comptroller of the Currency is planning to release an "Insight Report" in 2012 that will highlight the role SBICs play in assisting banking entities with obtaining qualified investment credit under the CRA and thereby meet the convenience and needs of their respective communities through CRA.

Question 310. Should venture capital funds be excluded from the definition of "covered fund"? Why or why not? If so, should the definition contained in rule 203 (l)-1 under the Advisers Act [Investment Advisers Act of 1940] be used? Should any modification to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Yes. Similar to SBICs, venture capital funds make long-term investments in small businesses, which foster innovation, create jobs and enhance our nation's global competitiveness. The positive impact of venture capital investments vastly outweighs the risk of allowing such investments. They do not pose systemic risk to our financial system and we are not aware of any venture capital fund investment ever threatening the safety and soundness of a banking institution.

The SEC's definition of a venture capital fund in Rule 203(l)-1 of the Advisers Act should work under the Volcker Rule, with a few modifications. Two important modifications are to include funds that make loans to small business (venture lending funds) and funds that invest only in other venture funds (venture funds of funds), so that banking entities are not prohibited from investing in any entity that safely provides long-term capital to our nation's small businesses.

Permitting banking entities to invest in venture capital funds also meets the standards in section 13(d)(1)(J). Venture capital investments promote and protect safety and soundness by providing banks with market information and insights that allow them to make better credit decisions, and forcing banks to divest of existing investments could negatively impact safety and soundness because forced sales usually result in losses. Venture investments also promote and protect financial stability in the same way as investments in SBICs and other public welfare investments. Venture funds provide capital to small and new businesses, which have a more difficult time obtaining capital than larger and more established enterprises. Allowing banking entities to continue to provide funding to this sector of the economy promotes financial stability, and not restricting this flow of capital protects it.

Question 378. Do banking entities currently invest in or sponsor SBICs and public welfare and qualified rehabilitation investments? If yes, to what extent? What are the benefits and costs associated with the [P]roposed [R]ule's implementation of the exception for investment in SBICs and public welfare and qualified rehabilitation investments?

Banking entities make up a significant portion of the private capital base of SBICs. As previously mentioned, in FY2011, there were 46 bank-owned SBICs compared to 143 traditional Debenture SBICs. As we have noted previously, if a banking entity is an investor in a Debenture SBIC, its capital can be matched by the SBA at a 2-to-1 leverage-to-private capital ratio. The combined private capital and SBA leverage can then be invested in U.S. job-creating small businesses. Again, we confine our comments to our area of principal expertise, SBICs.

For example, in FY2011 the 22 private funds that were successfully licensed as SBICs had raised an aggregate of $840 million in private capital, a sizeable jump from the $655 million of the 23 SBICs licensed in FY2010.[7] This trend highlights the weight the SBA places on the ability of a fund to raise private capital when determining whether to grant the fund licensure as an SBIC, and it is our belief that much of this private capital was raised through bank investment. Therefore, the more bank investment that a potential SBIC can attract to its private capital pool, the greater the likelihood that the potential SBIC will be licensed and then able to use the SBA leverage multiplier in providing capital to American small businesses.

Small businesses and entrepreneurs will significantly benefit by the exception in the Proposed Rule permitting bank investment in SBICs. We believe that Congress shares our strong view that SBICs are becoming ever more critical to efforts to grow the U.S. economy, improve prospects for job creation and foster a positive business investment climate, as evidenced by an annual Congressional authorization of $3 billion in each of the last six years. Indeed, in FY2011, SBICs invested a record $2.59 billion in small businesses, a billion more dollars than FY2010's $1.59 billion invested, which was then a record for the SBIC program. Continued, unrestricted bank investment into SBICs will ensure they can continue to fill a crucial capital void for job-creating small businesses.

As stated previously, a sizeable percentage of all SBICs were bank-owned in FY2011. Accordingly, the exception in the Proposed Rule allowing banks to sponsor SBICs is necessary and will greatly benefit small businesses and entrepreneurs. In sponsoring SBICs, banks provide management advice to the SBICs throughout their existence. Banks can use their expertise to manage the SBICs that they sponsor to foster economic growth and job creation. As such, the exception allowing banks to sponsor SBICs has significant public benefits.

As to the benefits and costs, as noted above, the Alliance strongly believes the track record of SBICs shows the considerable benefit to small businesses, to the U.S. economy and to the nation

---

[7] Id.

as a whole from the operation of SBICs. The Proposed Rule would further encourage the use of SBICs by banks which in turn will lead to additional benefits of the sort, just described. As to the costs, the Alliance is not in a position to comment on the overall cost associated with the implementation of the Volcker Rule, but we can definitively present our views with respect to the cost of the Proposed Rule related to SBICs. In short, any such costs are negligible because the Proposed Rule contains express permission for the continued organization and growth of SBICs as supported by banks. There likely will be compliance and other related implementation costs associated with the Proposed Rule but any such costs are far outweighed by the resulting economic growth and job creation benefits of the Proposed Rule which permits banks to organize, sponsor and invest in SBICs.

We thank you for the opportunity to submit these comments. Please feel free to contact the undersigned at 202-628-5055, or our counsel, Mr. Tim McTaggart or Mr. Doug Camitta at Pepper Hamilton LLP, 202-220-1210 or 202-220-1254, if you need any assistance from The Alliance.

Sincerely,

Brett Palmer

Attachment 1

SBIC Program
Bank-Owned SBIC Licensees
Fiscal Year 1993 to 2011
prepared: January 23, 2012

Fiscal Year	Number of Bank-Owned SBICs	Combined Private Capital ($ in millions)	Combined Leverage from SBA ($ in millions)
1993	66	$1,657.5	$82.0
1994	67	$1,726.8	$60.2
1995	69	$2,184.5	$35.0
1996	69	$3,118.3	$21.0
1997	79	$3,468.0	$18.5
1998	84	$4,005.4	$23.5
1999	102	$5,406.5	$38.9
2000	91	$6,196.5	$19.7
2001	92	$6,088.7	$20.2
2002	87	$5,392.1	$23.2
2003	82	$5,440.0	$14.7
2004	75	$5,206.2	$19.5
2005	66	$4,508.5	$18.0
2006	59	$3,127.4	$17.0
2007	47	$1,529.7	$10.0
2008	43	$1,464.0	$0.0
2009	34	$1,402.8	$0.0
2010	32	$1,300.0	$0.0
2011	27	$ 886.9	$0.0