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# Capital-Raising Alternative for Middle Market Companies: Small Business Administration's SBIC Program

Navigating Funding and Licensing Requirements to Access Leverage Commitments

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TUESDAY, APRIL 24, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

Michael K. Wyatt, Partner, **Foley Hoag**, Washington, D.C.

Alan B. Roth, Partner, **Edwards Wildman Palmer**, Chicago

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***DESCRIPTION OF THE SMALL BUSINESS  
INVESTMENT COMPANY PROGRAM  
PARTICIPATION BY FUNDS USING DEBENTURES***

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March 2012

## **THE SBIC PROGRAM**

A Small Business Investment Company (“SBIC”) is a privately owned and operated company that makes long-term investments in American small businesses and is licensed by the United States Small Business Administration (“SBA”).

The principal reason for a firm to become licensed as an SBIC is access to financing (“Leverage”) provided by SBA. In addition, very significantly, banks specifically are permitted to investment in SBICs under the recently adopted Dodd-Frank legislation as an exception to the Volker Rule.” This affords banks and Federal savings associations (as well as their holding companies) the ability not only to own more than 3% of investment funds which are SBICs, but also to own or to invest in SBICs and thereby to own indirectly more than 5% of the voting stock of a small business<sup>1</sup>. Banks, Federal savings associations and their holding companies also receive Community Reinvestment Act Credit for SBIC investments; and, in the case of banks and their holding companies, historically have received exemptions from certain capital charge regulations and lending “affiliation” rules under the Gramm-Leach-Bliley Act.

This document provides a summary description of SBA Leverage in the form of debentures and a general overview of other SBA regulations and policies.

### **The U.S. Small Business Administration**

The SBA administers the SBIC Program through its Investment Division (which employs approximately 80 people). SBA is an independent Federal agency. SBA is located at 409 Third Street SW, Washington, DC 20006, 202.205.6510. Useful information about the SBIC Program is available on SBA’s website at [www.sba.gov/INV](http://www.sba.gov/INV) or may be obtained by contacting Ms. Margaret Dennin (202.205.6234) or Mr. Scott Schaefer (202.205.6514).

### **SBIA**

The SBIC industry is served by an active trade association, the Small Business Investor Alliance (“SBIA”) (formerly known as the National Association of Small Business Investment Companies), which is located at 1100 H Street NW, Suite 610, Washington, DC 20005 (202.628.5055), [www.sbia.org](http://www.sbia.org). SBIA’s President is Mr. Brett Palmer. SBIA provides a variety of information and services to its members and represents the industry with SBA and on Capitol Hill. SBIA publishes a regular newsletter and is a resource for information concerning the SBIC Program.

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<sup>1</sup> However, the favorable capital treatment currently is being reviewed by applicable regulatory authorities in light of recent international agreements concerning the maintenance of certain principles when determining the capital requirements of banks.

## **Historical Perspective**

Established by the United States Congress in 1958 to stimulate long-term investment in American small businesses, the SBIC Program has evolved into a significant factor in financing smaller American businesses. Over the years, SBICs have provided over \$60 billion of funding to more than 112,000 businesses, including well-known companies such as Apple Computer, Federal Express, Cray Computers, Callaway Golf and Outback Steakhouse.

The SBIC Program has undergone significant changes since its creation in 1958. During the 1960s, more than 1,000 SBICs were in operation, a number of which specialized in real estate activities. Many of these were capitalized with the minimum private capital (initially \$150,000) and were managed by people without significant prior venture capital experience. Many of these early SBICs were commercially unsuccessful and most were short lived. During the 1970s, the 300-500 operating SBICs showed considerably more investment expertise, and the SBIC Program played a leading role in the venture capital industry. During the 1980s, extremely high interest rates (that later fell) accentuated the structural problem of making long-term equity investments using current-pay Debentures as a financing source. In addition, other regulatory features of the SBIC Program (such as total Leverage being limited to \$35 million which encouraged small private capitalization (\$12 million being required to use all the Leverage) which in turn led to investments in very small businesses), coupled with the rise of large venture capital firms and the emergence of pension funds and endowments as significant providers of capital to the venture industry (which for Federal tax reasons were discouraged from investing in SBICs using Debentures), caused the SBIC industry to decline during the 1980s. By the early 1990s, only 180 SBICs continued in operation, of which approximately 80 did not use Leverage and were owned by banks.

In 1991, SBA appointed an Advisory Commission that reviewed the SBIC industry's performance, determined that it had a significant role to play in building the U.S. economy, and outlined significant program changes required to make the program successful. The principal features of the Advisory Commission's report were embodied in legislation known as the "Small Business Equity Enhancement Act of 1992" (the "1992 Act"). The 1992 Act drastically changed the SBIC Program. It created a new form of SBA Leverage known as "Participating Securities" (preferred limited partnership interests); increased the amount of Leverage available to an SBIC to \$90 million (which subsequently was indexed to reflect changes in the cost of living since March 31, 1993 and then modified in 2009 to be \$150 million); required minimum private capital of \$10 million for SBICs using Participating Securities and \$5 million for SBICs using Debentures; provided for stricter SBA licensing standards; and proposed other changes to make the program more consistent with the private venture capital industry. Regulations implementing the 1992 Act became effective on April 25, 1994. The Act and regulations have undergone several revisions since 1994 that have further streamlined and improved the program.

From the summer of 1994 through September 30, 2011, 512 SBICs were licensed. As of September 30, 2011<sup>2</sup>, there were 97 SBICs using Participating Securities with aggregate private capital of \$2.28 billion and 143 SBICs using Debentures, with aggregate private capital of \$5.15 billion. There also were 46 unleveraged (including bank owned) SBICs with private capital of \$1.39 billion and 13 “specialized” SBICs (investing in businesses owned by socially or economically disadvantaged persons) with \$88.3 million of private capital.

In the fiscal year ended September 30, 2011, SBA licensed a total of 22 SBICs as follows: 18 Debenture and 4 unleveraged SBICs; and SBICs invested \$2.83 billion in 1,339 companies.

### **“Termination” of the Participating Securities Program**

Following the burst of the “technology bubble” in 2002, the Administration decided there no longer was a need for an equity SBIC program and that the existing Participating Securities Program would cause significant losses to SBA. The decision also reflected a broader Administration belief that the government should not participate in financing equity investments. Accordingly, SBA decided to terminate the Participating Securities Program and announced that beginning October 1, 2004, it neither would issue new commitments to use Participating Securities nor license new SBICs that planned to use Participating Securities. SBA continued to honor existing commitments for Participating Securities, the last of which expired on September 30, 2008. SBIC industry officials disagree with SBA’s position with respect to the equity program and have continued to work with Congress in an effort to devise an acceptable replacement for the Participating Securities Program.

### **Continuation of Debenture Program**

SBA officials continue to emphasize that they believe the Debenture Program is working well and they expect it to continue. SBA is actively seeking new applicants for the Debenture Program. Since the financial meltdown in the fall of 2008, there has been a very significant increase of interest by the private sector in the Debenture Program, and a number of well known private equity funds and institutional investors have formed and invested in SBICs.

### **SBA Leverage**

SBA currently provides financing (called “Leverage”) to SBICs in the form of “Debentures”. Debentures are unsecured loans issued by the SBIC that have interest only payable semi-annually and a ten-year maturity. The interest rate is established when issued, and recently has been between 85 and 130 basis points in excess of the interest rate on Treasury Notes with 10-year maturities (the “Treasury Note Rate”). As of December 31, 2011, there were

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<sup>2</sup> SBICs that have surrendered their licenses or have been transferred to the Office of Liquidation are not included in these figures.

\$4.44 billion of Debentures outstanding, plus \$1.93 billion of undrawn commitments to issue Debentures.

In addition, SBA has created “LMI Debentures” for use by SBICs making investments in Low and Moderate Income Zones (“LMI Zones”) that are more fully described below under the heading “LMI Investments.” A limited amount of LMI Debentures has been issued. SBA also is expected this summer to issue final regulations authorizing a limited amount of so-called energy saving Debentures which would enable SBICs licensed after 2008 to acquire equity securities in energy saving qualified investments.

SBA announced in January 2011 the launch of an impact investment fund program and an early stage innovation fund program, each using an aggregate of \$1 billion of Debenture Leverage, to be deployed in equal amounts over five years, commencing with the Federal fiscal year beginning October 2011. The impact investment fund program would license funds that invest growth capital in companies located in underserved communities (including economically distressed areas) and in designated sectors, including clean energy and education. They are limited to using a total of \$80 million of Debentures, but are afforded a somewhat expedited licensing process. As of the present date one such impact investment fund has been licensed. The early stage innovation fund program would license funds that invest at least half their capital in funds that have not yet achieved positive cash flow (follow-on investments in companies that initially qualified are included in this requirement). Draft regulations for the early stage SBIC program were published in December and SBA is in process of analyzing the comments it received prior to February 7, 2012. Final regulations are expected sometime during the late Spring or summer of 2012, and it is uncertain whether SBA will be in position to license new early stage funds under this program prior to the end of its September 31, 2012 fiscal year. Under the proposed regulations an SBIC licensed under the early stage innovation program must have minimum private capital of \$20 million and could seek Debenture Leverage in an amount up to its private capital, but not more than \$50 million.

### **Requesting Leverage**

SBICs obtain Leverage by obtaining a “Leverage Commitment” and then drawing down Leverage from the Commitment. Leverage Commitments may be obtained at the time of licensing for an amount up to one tier<sup>3</sup> of Leverage (subject to availability) and as needed thereafter, but not more than twice in any Federal fiscal year (October 1 – September 30). When a Leverage Commitment is issued, the SBIC pays a “one time” commitment fee that is 1% of the amount of the Commitment. Commitments expire on September 30 of the fourth Federal fiscal year following the fiscal year of their issuance.

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<sup>3</sup> A “tier” is SBA jargon for the amount of an SBIC’s Regulatory Capital (paid-in capital plus unfunded commitments from investors having sufficient financial means to qualify as “Institutional Investors”). SBA permits well performing Debenture SBICs with seasoned portfolios to use a “third tier” of Leverage in certain circumstances. See the section below entitled “Just in Time Financing”.

SBICs may draw down committed Leverage on one day's notice through an interim credit facility provided by the Federal Home Loan Bank of Chicago. At the time of each disbursement, fees totaling 2.425% are deducted from the amount the SBIC receives (a 2% "user" fee payable to SBA, 37.5 basis points of underwriting fees and 5 basis points as an administrative fee to the Selling Agent).<sup>4</sup> The SBIC pays an interim interest rate on Debenture Leverage of LIBOR plus 30 basis points and the amount of SBA's "Fee" described below. Every six months, all interim Leverage is pooled by SBA and a new interest rate for Debentures is established which is then fixed until the Leverage is repaid. Debentures are pooled in March and September of each year.

SBA only will issue "one-half tier" of Leverage to a newly licensed SBIC before SBA conducts its first regulatory examination (6-10 months after licensure).

### **Typical Use of Leverage**

A management team may hold a closing and form its fund at any time shortly before or after it files its formal SBIC application.<sup>5</sup> However, it may not obtain Leverage until it receives its license, a process that is currently taking about six months for new applicants. After the license application is accepted by SBA for processing, many applicants draw their private capital to pay organization expenses, management fees and make investments. In any event, they are required to have drawn at least \$2.5 million of private investors' capital prior to licensing. Once licensed, most SBICs fund their operations solely by using SBA Leverage until the ratio of outstanding Leverage to paid-in capital from private investors (called "Leverageable Capital") reaches two-to-one, and they then coordinate capital calls from private investors with the use of Leverage to maintain a two-to-one Leverage ratio.<sup>6</sup> SBICs are permitted to borrow money from banks or other unaffiliated third parties prior to their initial Leverage draw which SBA requires to be repaid when Leverage is first drawn.

### **Leverage Availability**

The stimulus legislation enacted in 2009 increased available Leverage for a single SBIC to \$150 million and Leverage for a group of commonly managed SBICs to an aggregate of \$225 million.<sup>7</sup> Prior to the stimulus legislation, for the fiscal year ending September 30, 2009,

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<sup>4</sup> Prior to February 2006 the underwriter's fee was 50 basis points.

<sup>5</sup> See the section below entitled "Licensing".

<sup>6</sup> SBA policies, however, require that an SBIC must have invested in portfolio companies at least 50% of the Private Capital that it had drawn prior to receipt of Leverage. Some SBICs that have incurred sizeable organization expenses and/or management fees prior to making investments have found it necessary to draw more than \$2.5 million of Private Capital in order to comply with this policy. Additionally, Debenture funds may draw at a three-to-one ratio in certain circumstances.

<sup>7</sup> The regulations implementing the New Markets Venture Capital Program Act of 2000 provide that an SBIC may have outstanding Leverage in excess of the generally applicable Leverage ceiling based on investments in "low income geographic areas." For SBIC's licensed before October 1, 2009, the Leverage ceiling is calculated without regard to the amount of the cost basis of equity investments in "Smaller Enterprises" located in a "low income geographic area" (but only to the extent that such amounts do not exceed 50% of the SBIC's "Leveragable  
(continued...)

SBA Regulations provided that the maximum amount of Leverage available to an SBIC (or a group of commonly controlled SBICs) was \$137.1 million (\$90 million indexed for increases in the Consumer Price Index after March 31, 1993). The amount of Leverage available to a particular SBIC is limited to a multiple of its paid-in private capital.

SBA obtains funds enabling it to supply Leverage by guarantying payment of Trust Certificates that are purchased by traditional purchasers of government-guaranteed notes. SBA then invests the proceeds in SBICs in the form of Debentures. SBA Guaranteed Trust Certificates are sold for Debentures in March and September of each year.

The amount of Debentures that may be issued each year is subject to the amount authorized by Congress. In recent years, Congress has enacted authorized levels in three-year cycles. For the fiscal year ending September 30, 2012, \$3 billion of Debentures is available. The Administrations has proposed that the authorized level for the fiscal year ending September 30, 2013 be increased to \$4 billion.

Trust Certificates are sold with the assistance of investment bankers (who receive a 37.5 basis point fee) to institutional purchasers of government-guaranteed, fixed rate notes with 10-year maturities. The purchasers require a premium over the interest rate on Treasury Notes with 10-year maturities. The amount of this premium fluctuates with economic conditions at the time the notes are sold. The premium over the 10-year Treasury Note rate was 1.035% for the \$238.295 million Debenture pooling in September 2007, but in reaction to the professed desire to invest in more liquid securities by the traditional purchases, the premium rose to 2.078% in March 2008 and to 2.273% in the \$360.745 million pooling in September 2008. In the March 2009 pooling the premium declined to 1.68%, declined further to 0.765% in the September 2009 pooling, and declined to the historically low level of 0.47% in the March 2010 pooling. In the September 2010 pooling of \$562.985 million, the premium rose slightly to 0.545%, in the March 2011 pooling of \$822 million (which was the largest pooling in the history of the program), the premium rose to 0.743%, and in the September 2011 pooling of \$558.685 million, the premium rose to 0.923%.

Historically, the amount of Debentures that could be issued each year was subject to annual Congressional appropriation of an amount necessary to cover anticipated losses on the Leverage issued. Thus, the amount of Congressional appropriation and the rate of loss anticipated on the issued Leverage (referred to as the "Subsidy Rate") determined the actual amount of available Leverage each year that typically was significantly less than the level "authorized" by Congress. Beginning on September 1, 1996, SBA charged a 1.00% annual "Charge" on Leverage it provided to SBICs, causing significant reductions in required

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(continued...)

Capital"). For SBIC's licensed from and after October 1, 2009, the single SBIC leverage ceiling is increased to \$175 million and the aggregate ceiling for a group of commonly managed SBIC's is increased to \$250 million if at least 50% of each such SBIC's financings has been and will be invested in "Small Businesses" located in a "low income geographic area."

Congressional appropriations needed to support increasing amounts of available Leverage. The amount of the “Charge” is determined in the fiscal year in which a Leverage Commitment is issued and applies to all Leverage issued pursuant to that Commitment. The Subsidy Rate was substantially reduced in the case of Debentures, to less than 1.00% with the result that no appropriations were required to support their issuance beginning in FY 2000.

In December 2000 legislation was enacted requiring SBA to set the amount of the Charge it imposed on Commitments issued each fiscal year at the rate necessary so that the sum of all fees charged (including 1% commitment fees, 2% user fees, the annual “Charge” and anticipated profit distributions) would equal the amount of anticipated losses. The Charge for Debenture Commitments issued in FY 2007 was approximately 0.91%, and was 0.72% in FY 2008. The Charge declined to 0.41% for FY 2009 and declined further to 0.285% for FY 2010 and then rose to 0.515% for FY 2011. The Charge for Debenture Commitments issued in FY 2012 is 0.804%.

As a point of reference, the amounts of Leverage available since FY 2001 have been as follows:

	<b><u>PARTICIPATING SECURITIES</u></b>	<b><u>DEBENTURES</u></b>
FY 2001	\$2.000 billion	\$1.00 billion
FY 2002	\$3.500 billion	\$2.50 billion
FY 2003	\$4.000 billion	\$3.00 billion
FY 2004	\$4.000 billion	\$3.00 billion
FY2005	N/A	\$3.00 billion
FY2006	N/A	\$3.00 billion
FY2007	N/A	\$3.00 billion
FY2008	N/A	\$3.00 billion
FY2009	N/A	\$3.00 billion
FY2010	N/A	\$3.00 billion
FY2011	N/A	\$3.00 billion
FY2012	N/A	\$3.00 billion
FY2013	N/A	\$4.00 billion (proposed)

SBA’s website ([www.sba.gov/INV](http://www.sba.gov/INV)) contains historical information concerning the amount and pricing of Leverage committed and issued since the SBIC Program was restructured in 1994.

**Summary of Calculation of Interest Rate Charged on Debentures**

The rate of interest payable by an SBIC on Debentures is the sum of the following:

1. The interest rate of Treasury Notes with 10-year maturities at the time the Trust Certificates are pooled and sold;

2. The premium required by the purchasers of the Trust Certificates above the 10-year Treasury Note Rate; and

3. The annual Charge payable to SBA at the rate applicable in the fiscal year in which the Commitment was issued.

Thus, for example, the interest rate for Debentures issued in the September 2011 pooling pursuant to a Debenture commitment issued during FY 2011 was:

1.954%	10 Year Treasury Rate
0.923%	Premium required by Trust Certificate purchasers
<u>0.515%</u>	SBA Charge for Debenture Commitment issued in FY 2011
<b>3.392%</b>	<b>Total Interest Rate</b>

#### **Debenture Leverage**

Debentures have 10-year maturities, are not amortized prior to maturity, and bear interest payable semi-annually at a rate that, for Debentures pooled in March 2011, was 0.743% plus the applicable SBA Charge<sup>8</sup> in excess of the Treasury Note Rate (which was 3.341%). Debentures are unsecured, and the General Partner of the SBIC is not personally liable for their repayment. Beginning with the September 2006 issuance, Debentures may be prepaid without penalty. Debentures issued before September 2006 may be prepaid with a 5% penalty in the first year that declines 1% per year (i.e., 5-4-3-2-1%) so that the Debentures may be prepaid without penalty beginning in the sixth year following issuance. Repayment of Debentures is subordinate to repayment of loans from non-Associate lenders up to the lesser of \$10 million or twice the amount of the SBIC's Regulatory Capital (i.e., its capital from private investors). SBA is able to issue Debentures with maturities shorter than 10 years, but has not done so since 1991. Historically, SBA has restricted use of the "third tier" of Debentures until the SBIC has demonstrated it is operating profitably. The maximum leverage available to a single SBIC is \$150 million of Debentures and a group of commonly managed SBICs may use up to \$225 million of Debentures.<sup>9</sup>

Prior to October 2004, certain tax-exempt entities that invested in SBICs were subject to recognition of unrelated business taxable income ("UBTI") as a result of the issuance of Debentures. Tax legislation adopted in October 2004 exempts tax-exempt investors from UBTI that otherwise would be caused by the use of Debentures by SBICs licensed after enactment of the legislation, but only if no such tax-exempt investor owns more than 25% of the

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<sup>8</sup> Determined by the date of the commitment used to draw the Debentures.

<sup>9</sup> See footnote 7 which described when SBIC's may have outstanding Leverage in excess of these amounts based on investments made in "low income geographic areas."

capital or profits interest of the SBIC and all tax-exempt investors own less than 50% of the capital and profits interest of the SBIC.

### **Distributions by Debenture SBICs**

SBICs using Debentures may distribute their undistributed net realized, cumulative earnings less unrealized depreciation to investors. However, without SBA's prior consent (which SBA is unlikely to give), they may not reduce their capital to investors by more than 2% in any fiscal year.<sup>10</sup> After completion of their "investment periods," SBICs are required to submit a "Wind-Up" plan to SBA indicating when and how the SBIC intends to liquidate its assets and repay SBA. SBA's written guidelines for such plans indicate its principal concern is to assure repayment of outstanding Debentures. However, several SBICs that have performed well and previously have repaid some of their Debentures have been able to negotiate Wind-Up plans that enable them to make certain distributions returning capital to their investors prior to repaying all of their outstanding Debentures.

### **Just in Time Financing**

The SBIC Program permits the funds from investors and SBA Leverage to be taken down by the Partnership in "lock step", thereby delaying investor capital calls and increasing investor returns. An SBIC using Debentures is required to have total "Regulatory Capital" (paid-in capital plus unfunded binding commitments from "Institutional Investors") of at least \$5 million. However, in the past year SBA has required SBICs to have firm commitments when their formal license application is filed for an amount of capital that is sufficient to enable them to have a first closing and conduct their operations even if they do not subsequently raise additional funds. While an applicant needs to have binding subscriptions for the full amount of its "Regulatory Capital" only \$2.5 million of the SBIC's Regulatory Capital needs to be paid-in prior to issuance of the SBIC License. Once at least one-half of this \$2.5 million is invested, the SBIC will be eligible to use SBA Leverage prior to having another capital call from investors.

SBA regulations describe the qualifications of "Institutional Investors". They can be most forms of business entities with a net worth of at least \$10 million, or banks or savings and loan associations or their holding companies, insurance companies, pension plans for private or public sector employees, and tax-exempt foundations or trusts, in each case with a net worth of at least \$1 million. Institutional Investors also include individuals with a net worth of at least \$10 million (exclusive of the equity of their most valuable residence) or \$2 million if the amount committed to the SBIC does not exceed 10% of their net worth. Not more than 33% of the

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<sup>10</sup> This restriction on distributions may cause a "phantom income" issue when an SBIC using Debentures realizes income in a year that does not exceed the amount of prior cumulative net losses. Distribution of such "income" would reduce the amount of the SBIC's Regulatory Capital and, therefore, is subject to the 2% limitation. While investors may have received the benefit of deductions for these losses in prior years (although use of such losses is severely restricted for individuals), they may incur phantom income in the year in which such profits arise. This restriction also may cause operating issues for SBICs whose limited partnership agreements restrict the reinvestment of realized investment proceeds.

SBIC's private capital may be invested by government entities. If an Institutional Investor has a net worth of less than \$10 million, only that part of its unfunded commitment that is less than 10% of its net worth will be included in Regulatory Capital.

### **LMI Debentures**

On September 30, 1999, SBA adopted regulations providing incentives for SBICs to invest in Low and Moderate Income Zones ("LMI Zones"). Debenture SBICs also may use LMI Debentures. Highlights of the regulations are as follows:

An LMI Zone is a geographic area that satisfies one of five definitions that currently are used by different Federal agencies in determining areas requiring special attention.

1. SBICs making venture capital type investments (equity or certain subordinated loans) in small businesses with 50% or more of its employees or tangible assets in an LMI Zone, or to a small business that has 35% of its employees residing in an LMI Zone, will be eligible to obtain SBA financing in the form of a deferred interest Debenture. SBA intends to issue non-amortizing Debentures with maturities of 5 or 10 years, each with a "zero coupon" for the first 5 years. If the interest rate is 7%, this means that the SBIC would receive approximately \$71,000 in proceeds for issuing a \$100,000 Debenture. On the 10-year Debentures, interest would be payable semi-annually commencing in the 6th year.

2. The Small Business financed by the SBIC must either satisfy the employee or asset test described above at the time of applying to the SBIC for financing, or within 180 days after the closing of the financing.

3. LMI Debentures will be issuable to SBICs that have reserved Debenture Leverage. At the time of making a draw request, the SBIC will specify whether it will use an LMI Debenture or a regular Debenture. The interest rate for the LMI Debenture is fixed when it is initially issued for its full term. LMI Debentures will be held by the Federal Home Loan Bank of Chicago and are not pooled in the same manner as other Leverage.

### **Community Reinvestment Act Credit**

Current Community Reinvestment Act ("CRA") regulations present banks (other than certain "small banks") with a continuing need to make investments that qualify for CRA purposes. Investment in an SBIC is specifically identified in the CRA regulations as a type of investment that will be presumed by the regulatory agencies to be a "qualified investment" for CRA purposes. The investment should be in an SBIC that is located in or doing substantial business in the region in which the bank's assessment area is located, but the SBIC is not required to be headquartered within the assessment area itself. The SBIC Act and other Federal statutes explicitly permit banks, bank holding companies, Federal savings associations and savings and loan holding companies to invest in SBICs.

### **Gramm-Leach-Bliley Act Exemptions**

As part of the implementation of the Gramm-Leach-Bliley Act (the “GLB Act”), effective April 1, 2002, the Federal Reserve Board, the FDIC and the Office of the Comptroller of the Currency adopted new regulations governing regulatory capital treatment for certain equity investments held by banks, bank holding companies and financial holding companies. Under the regulations, an 8% Tier 1 capital deduction applies on covered investments that in the aggregate are less than 15% of an organization’s Tier 1 capital, a 12% deduction applies to investments aggregating 15-24.99% of Tier 1 capital, and a 25% deduction applies to investments aggregating 25% and above of Tier 1 capital. The regulations exempt SBIC investments from such capital charges so long as their value is less than 15% of Tier 1 capital. However, the amount of SBIC investments will be considered when determining capital charges with respect to other investments. Agreements reached during the Basil 2 Accords have put in questions whether the favorable capital charge treatment will be continued.

In addition, ownership of a 15% equity interest in a portfolio company by a bank-affiliated SBIC will not give rise to a presumption that the portfolio company is an Affiliate under Sections 23(a) and (b) of the GLB Act.

### **Investment Advisers Act Exemption**

Advisers that solely advise SBIC’s, entities that have received their “green light letter” to submit their formal license application to SBA and applicants that are affiliated with one or more SBIC’s that have applied for another SBIC license are expressly exempted from the new requirements under the Dodd-Frank Act amendments to the Investment Advisers Act of 1940 which require advisers to certain types of private funds to register with the Securities and Exchange Commission. However, they may still be subject to certain state registration requirements. SBIC managers who also manage other funds also will be subject to registration requirements unless appropriate exemptions apply.

### **SBIC Investments**

An SBIC only may invest in “Small Businesses”, and must invest at least 25% of its invested funds in “Smaller Enterprises.”<sup>11</sup> SBA regulations define a Small Business as a company with net worth (excluding goodwill) of less than \$18 million and average after-tax income (exclusive of loss carry-forwards) for the prior 2 years of less than \$6 million. Companies failing that test may still qualify if they meet certain size standards for their industry group under an alternative test. The size standards for industry groups under this alternative test are based on the number of employees (typically 500 to 1,000 for a manufacturing company) or gross revenues. A “Smaller Enterprise” is a company with a net worth (excluding goodwill) of less than \$6 million and average after-tax income for the prior 2 years of less than \$2 million or

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<sup>11</sup> The recently enacted stimulus legislation increased this from 20% plus an additional amount for SBICs using more than \$90 million of Leverage.

which meets the alternative test. Certain debt-to-equity ratios must also be met if the Partnership finances the change of ownership of a Small Business with more than 500 employees.

SBIC regulations restrict the size of the investments that an SBIC may invest in any company and its affiliates (the so-called “over-line limit”). The Stimulus Legislation of 2009 changed the over-line limit from 20% of “Regulatory Capital” to 10% of the sum of Regulatory Capital multiplied by the leverage ratio approved at the time of licensing (*i.e.*, 30% of Regulatory Capital if Regulatory Capital is fully leveraged with two tiers of Leverage). As a result of this change, if an SBIC receives private investments of \$20 million, it may not invest more than \$6 million in a single company without SBA’s approval (assuming it was approved for two tiers of Leverage at the time it was licensed as an SBIC.) SBA may approve a larger percentage if necessary to protect the SBIC’s investment, but has indicated it only will give such consent in unusual circumstances.

SBIC regulations preclude investment in the following types of businesses: companies whose principal business is re-lending or re-investing (venture capital firms, leasing companies, factors, banks); many kinds of real estate projects; single-purpose projects that are not continuing businesses; for use outside of the United States or have more than 49% of their tangible assets or employees outside the United States at the time of financing or within one year following the financing (unless the funding is used for a specific U.S. purpose that is acceptable to SBA); in businesses that are passive and do not carry on an active trade or business; and in businesses that use 50% or more of the funds to buy goods or services from an associated supplier.

Historically, SBA regulations prevented an SBIC (or two or more SBICs acting together) and its Associates (controlled or related persons) from controlling a small business except on a temporary basis to protect its investment or if the small business was a “start-up”. In December 2000, legislation was enacted eliminating the legislative basis for regulating “control during the investment period”. Effective November 21, 2002, SBA adopted final regulations indicating that an SBIC and its Associates may control a small business for up to 7 years, and with SBA’s consent, for a longer period, to permit an orderly sale of the investment or to ensure the financial stability of the small business.

SBICs are precluded from making investments in a Small Business if it would give rise to a conflict of interest. Generally, a conflict of interest may arise if an Associate of the SBIC has or makes an investment in the Small Business or serves as one of its officers or directors or would otherwise benefit from the financing. Joint investing with an Associate (such as another fund controlled by affiliates of the General Partner) may be made on the same terms and conditions and at the same time or on terms that are fair to the SBIC.

### **Financing Terms**

An SBIC may make investments in the form of Loans, debt with equity features (“Debt Securities”), or Equity Securities. Debt Securities must be issued for a term of not less than one year (except for bridge loans in anticipation of a permanent financing in which the SBIC intends to participate, or to protect its prior investment) and must have amortization not

exceeding “straight line”. The permissible interest rate on Debt Securities depends on whether they are “straight debt” or debt with equity features. For straight Loans, the permitted rate is the higher of (i) 19%, or (ii) 11% over the higher of the SBIC’s weighted cost of Debenture Leverage or the current Debenture Rate. For Debt Securities, the permitted rate is the higher of (i) 14%, or (ii) 6% over the higher of the SBIC’s weighted cost of Debenture Leverage or the current Debenture Rate. Regulations define an SBIC’s weighted cost of Debenture Leverage and describe the permitted rate when more than one SBIC participates in the financing.

In addition, SBICs may structure financing to receive a royalty based on improvement in the performance of a portfolio company after the financing.

The applicable interest rate is calculated using all points, fees, discounts and other costs of money other than application and closing fees of up to 5% of the financing (if it is a Debt Security, (i.e. debt with equity features) or 3% for Loans (without equity features), that may be charged in addition to the permitted interest. In addition, an SBIC may be reimbursed for its routine closing costs (including legal fees).

An SBIC may require a Small Business to redeem the SBIC’s equity investment, but only after one year, and only for a price based on a pre-determined formula based on the book value and/or earnings or a third-party appraisal by a mutually agreed upon, qualified appraiser. Mandatory redemptions not complying with these requirements will be treated as if they were Debt Securities. However, the Small Business may be required to redeem the SBIC’s equity security if the Small Business has a public offering, has a change of control or management or defaults under its investment agreement.

An SBIC may retain its investment in a business that ceases to be small, and may continue to invest in such a “large” business until it has a public offering. Following a public offering by such a “large” business, the SBIC still may exercise rights to acquire securities that were obtained while the business was small.

### **SBIC Operations**

SBA has adopted a number of regulations and policies concerning operating requirements of SBICs intended to assure their proper management. Principal regulations and policies include:

An SBIC using Leverage must invest its “idle funds” not invested in Small Businesses, in liquid, safe, short-term investments specified in the regulations (principally, U.S. government obligations, repurchase obligations, federally-insured deposits, and deposits in “well-capitalized” federally-insured financial institutions).

An SBIC and its Associates may provide management services to Small Businesses in which the SBIC invests, but only may charge for services at competitive rates for services actually rendered. SBA requires that SBICs applying for a license after April 1, 2004, must credit all such fees against the management fee otherwise payable by the SBIC to the management team (except for placement fees paid to associated licensed broker-dealers).

The General Partner or Board of Directors is required to value the SBIC's assets annually (semi-annually, if Leverage is used) pursuant to valuation guidelines approved by SBA. SBA has issued model valuation guidelines that are similar to those customarily used by venture capital firms, but do not conform with generally accepted accounting principles.

An SBIC's ability to borrow funds from third parties is subject to SBA regulation. SBICs may only incur unsecured debt.

SBICs are required to file a variety of reports with SBA, none of which generally are considered burdensome. These reports include an annual financial statement which is certified to by the SBIC's independent certified public accountants (and contains information concerning each portfolio company), valuation reports as described above, capital certificates reporting, among other things, changes in "Regulatory Capital" and "Leverageable Capital", reports as to changes in the SBIC's management, material litigation, a brief report describing each investment, and copies of reports sent to investors and, if applicable, to the SEC. SBA will conduct regulatory examinations of each SBIC on an annual basis.

A key regulatory metric for SBA is the extent of "Capital Impairment," which is the extent of realized (and, in certain circumstances, net unrealized) losses of an SBIC compared with the SBIC's private capital commitments. Interest payments, management fees, organization and other expenses are included in determining "realized losses". SBA regulations preclude the full amount of "unrealized appreciation" from portfolio companies from being considered when calculating Capital Impairment in certain circumstances. If an SBIC issues Leverage, it will be required to avoid Capital Impairment. Capital Impairment will be considered to exist if the SBIC's "Capital Impairment Ratio" (calculated by adding the SBIC's realized losses and net unrealized depreciation<sup>12</sup> and dividing the result by the SBIC's private capital) exceeds permitted levels detailed in the regulations and which vary depending on the proportion of equity investments made by the SBIC.

SBA has certain rights and remedies if the SBIC violates SBA regulations, which include being in a condition of Capital Impairment. Remedies for regulatory violations are graduated in severity depending on the seriousness of Capital Impairment or other regulatory violation. For minor regulatory infractions, warnings are given. For serious infractions the use of Debentures may be limited or prohibited, outstanding Debentures can be declared to be immediately due and payable, restrictions on distributions and making new investments may be imposed, management fees may be required to be reduced, and investors may be required to pay their unfunded capital commitments to the SBIC. In severe cases, SBA may require the Limited Partners to remove the Partnership's General Partner or its officers, directors, managers or partners, or SBA may obtain appointment of a receiver for the Partnership.

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<sup>12</sup> The actual calculation is complex as certain types of unrealized appreciation are not fully credited.

## **Organization**

SBICs are organized under state law as corporations, limited partnerships or limited liability companies. SBA strongly encourages Debenture SBICs to be organized as limited partnerships.

## **Investors**

Investors may be either domestic or foreign individuals or entities. The SBIC Act specifically authorizes banks and Federal savings associations to invest up to 5% of their capital and surplus in SBICs. Certain investors owning 33% or more of an SBIC are required to submit certain background information to SBA and are subject to SBA's fingerprinting requirements. All investors in an SBIC and anyone owning 10% or more of any investor owning 10% of an SBIC must be identified to SBA in the SBIC's application for licensure.

## **Diversity of Ownership**

SBA has regulations and policies designed to assure that an SBIC receives significant investments from investors who do not participate in or otherwise control its management. Additionally, an SBIC must receive at least 30% of its private capital from a total of three or more investors who are unrelated to the management or from a single such investor meeting certain limited qualifications (such as a bank, insurance company or certain publicly traded corporations). No single investor may own more than 70% of an SBIC's private capital.

## **Restrictions on Transfer**

Investors in an SBIC may not transfer their interests without SBA's prior consent. Additionally, as a condition to providing Leverage to the SBIC, SBA presently requires investors owning 50% or more of an SBIC that uses Leverage (as well as the SBIC's managers and other "control persons") to enter into a written agreement with SBA providing for personal liability for repayment of Leverage for directly or indirectly participating in a change of control of an SBIC without SBA's prior consent. Additionally, without SBA's consent, an SBIC may not release any of its investors from the liability to make the full amount of their capital contribution.

## **Management Fee**

Management fees paid by SBICs using Leverage are subject to SBA's prior approval. Leveraged SBICs that submit license applications from and after April 1, 2004, are permitted to charge a management fee of up to 2.5% on three times the amount of "Regulatory Capital" (without subtracting distributions made) for five years, and thereafter 2.5% of the cost basis of loans and investments in active portfolio companies. However, if the base on which the fee is calculated exceeds \$60 million, the permissible rate declines to 2% when the base is \$120 million or more. SBA policies require that management fees be reduced by all consulting, board and other fees received from portfolio companies by affiliates of the SBIC's general partner (except for fees paid to licensed broker-dealers). SBICs that filed their license applications before April 1, 2004, are not required to offset fees from portfolio companies and are permitted to charge an annual management fee of 2.5% of three times the amount of

Regulatory Capital (without reduction for distributions) for five years and thereafter 2.5% of the amount of outstanding Regulatory Capital and Debentures that are issued and outstanding plus an additional \$125,000 may be paid each year when the base on which management fees was calculated is less than \$20 million. SBA only permits increases in Regulatory Capital to create a prospective entitlement to increased management fees (i.e., the increased level of management fees only may be charged from the beginning of the calendar quarter in which the Regulatory Capital is increased, not the date of the initial closing). SBA's policies concerning Management Fees are quite detailed and are set forth in Tech Note 7 and Tech Note 7A (pertaining to SBICs filing license applications beginning with April 1, 2004).

### **Licensing**

SBA uses a two-step licensing process for "first time" SBICs. In the first phase, an applicant completes an SBA form entitled Management Assessment Questionnaire ("MAQ"). This contains the elements of the applicant's business plan as well as detailed information concerning the experience of each of the "Principals" to carry out the business plan. SBA generally requires that at least two, substantially full-time, members of the team have at least five years of successful private equity investment experience at a decision-making level. The MAQ is then reviewed by SBA's "Investment Committee", after which the Principals, if appearing qualified, are invited to meet with the members of the Investment Committee. After the meeting with the applicant's Principals, SBA's Investment Committee may turn the application down or issue a "green light" letter to applicant indicating that it has passed the first part of the application process and now is authorized to file a formal application. At the present time, a "green light" letter usually is issued within three months following submission of the MAQ.

After receipt of the "green light" letter and obtaining commitments for at least the minimum required Regulatory Capital (\$5 million for SBICs using Debentures)<sup>13</sup> from investors satisfying the "diversity" requirement, the applicant files a formal application which contains additional information about the applicant and the management team, as well as its formal legal documents. During the formal licensing process, SBA seeks to determine that there is a qualified management team and that the SBIC has a good chance of operating profitably. SBA reviews the applicant's business plan, projections and legal documents, and conducts reference and other background checks on the management team. The process presently is taking approximately six months. SBA requires applicants to advise their investors that the investors are not entitled to rely on SBA's review of the applicant in deciding whether to invest.

After a license application is filed and accepted for processing by SBA, an applicant may make "pre-licensing investments" which will be included in the applicant's Regulatory Capital if they are submitted to SBA for approval prior to the investment being made.

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<sup>13</sup> During the last year, SBA has adopted a policy requiring Applicants to have firm and binding commitments for sufficient Regulatory Capital (typically \$15 million to \$20 million) to hold a first closing and conduct successful operations even if no additional capital subsequently is raised. During the last year SBA has given particular emphasis to validation of the credentials of the management team which is evidenced by successful fundraising. Investment in an SBIC applicant by institutional investors in prior funds is given particular weight during the licensing process.

SBA requires 10 business days to review such pre-licensing investments (but approvals frequently take longer). SBA does not seek to “underwrite” the investment. Rather, SBA simply seeks to determine if the investment is made in compliance with SBA Regulations. Once licensed, such pre-approval of investments is not required. SBA requires all principal members of the management team to attend a one-day regulations class run by SBA and will only permit one “pre-licensing” investment to be made prior to at least one person from applicant attending the class. Arrangements for attending the regulations class are made by contacting SBIA.

As of January 10, 2012, SBA was processing 24 license applications, and there were 31 outstanding “green light” letters.

### **Timeline**

Applicants should assume the following timeline for securing a license and Leverage.

Management Assessment Questionnaire	3 months
Formal License Approval	6 months
Receipt of Leverage Following Licensing	<u>1-2 months</u>
	10-11 months
Use of More than One-Half of One Tier of Leverage Following Licensing	6-10 months after licensing

This assumes the license application is filed immediately upon receipt of the “green light” letter.

### **Licensing Second Funds**

For “second” SBIC funds, SBA follows a process that is similar to licensing new funds. The first step consists of SBA’s Office of Operations analyzing the prior fund (similarity of business plan, changes in management team, track record, profitability, liquidity and prior SBA compliance record) and making a recommendation to the Investment Committee that ultimately leads to issuance of a “green light” letter. Following its receipt, when the new fund has received commitments for the minimum required capital that satisfies the “diversity” requirement, the fund may submit a formal application for processing. If the “second” fund continues the investment strategy of a successful SBIC and the management team is basically the same, SBA has adopted a new “fast track” licensing process designed to shorten the process to less than six months.

## PEPPER HAMILTON LLP

### **SMALL BUSINESS INVESTMENT COMPANY PRACTICE**

Pepper Hamilton LLP, with 11 offices and more than 500 lawyers, provides corporate, litigation and regulatory services to national and international companies, emerging businesses and individuals. The firm has the country's largest and most active Small Business Investment Company practice.

Pepper Hamilton serves the SBIC industry in the following ways:

- Fund formation
- Assistance in licensing
- Regulatory advice to licensed Small Business Investment Companies
- Fund investment activities
- Serving as counsel to portfolio companies
- Provision of advice concerning systematic improvements to the SBIC Program

Founded in 1890 in Philadelphia, Pepper Hamilton today has offices in Philadelphia, Pennsylvania Washington, D.C. and Detroit, Michigan, Wilmington, Delaware; New York, New York; Boston, Massachusetts; Berwyn, Pittsburgh and Harrisburg, Pennsylvania; Orange County, California; and Princeton, New Jersey.

### **Why Select Pepper Hamilton**

It makes sense for you to select Pepper Hamilton as your SBIC counsel for the following reasons:

**Experience.** Pepper Hamilton has enormous SBIC experience. **Mike Staebler** ran an SBIC for six years and has served as counsel to more than 200 licensed SBICs since 1972. He assisted NASBIC in negotiating the SBA regulations implementing the "new" SBIC program from 1992-94 and has provided advice to SBA in connection with the creation of many of its forms and policies. Since 1994, he has helped more than 165 SBICs become licensed by SBA. **Julie Corelli** has more than 20 years of fund formation and deal-related experience and has worked extensively with SBICs during the past five years. **Doug Camitta** has counseled dozens of SBICs for more than 25 years concerning regulatory matters, their formation and their investment activities and has provided counsel to SBA concerning a number of their forms and policies. **Vicki Harding** has more than 20 years of experience working with venture capital firms and technology-based companies. **Mike Temple** (ten years) has intensive experience in connection with the formation, licensing, regulatory and investment activities of SBICs. **Todd**

**Betke** and **Christopher Rossi** have extensive experience in fund formation and the investment activities of private equity, mezzanine and venture capital firms.

**Depth of Experience.** Establishing an SBIC requires extensive knowledge of partnership and corporate law, securities law, taxation (foreign and domestic) and ERISA laws, as well as in-depth knowledge of the SBIC Regulations. **Lisa Petkun** has provided SBIC tax advice for 25 years. **Joe Del Raso**, formerly an SEC attorney, and **Greg Nowak** advise hedge and other investment funds and have extensive expertise in 1940 Investment Company Act and 1940 Investment Advisers Act experience. **Brad Boericke** has extensive experience in advising financial institutions in SBIC investment. The firm has researched extensively the availability of **Community Reinvestment Act** credit for investments by financial institutions in SBICs as well as the interaction of state-sponsored economic development programs with SBIC requirements.

**Working with Your Regular Counsel.** The firm is equally happy to handle all aspects of your SBIC's formation and licensing, or to work in conjunction with your regular counsel. Pepper Hamilton has established excellent working relationships with many of the country's other leading law firms and regularly receives referrals from them.

**Cost Effective.** Having seen "almost all of it" before, the firm is equipped to provide informed, experienced advice to assist you in "getting it right" the first time.

### **Fund Formation**

Pepper Hamilton assists prospective SBICs in structuring their funds and raising private capital. The firm has a national perspective and extensive experience in negotiating relationships between principal fund managers and between fund sponsors and limited partners.

The firm regularly advises clients concerning all aspects of fund formation and management, including domestic and foreign tax structuring, ERISA and compliance with federal and state securities laws.

### **Licensing**

Pepper Hamilton has represented more than 170 firms in obtaining licenses as SBICs or SSBICs. Of these, over 165 have received their licenses since August 1, 1994. In addition, the firm represents numerous management teams in the process of fundraising or obtaining a license. These firms are located throughout the United States, are structured as limited partnerships, corporations and limited liability companies, and have investors that include large public and private pension funds, state and local governmental agencies, banks and bank holding companies, tax-exempt entities, individuals and foreign individuals and entities.

### **Regulatory Advice**

The firm provides ongoing regulatory advice to licensed SBICs covering the full range of SBA regulatory compliance.

### **Fund Investment Activities**

Pepper Hamilton regularly handles investments for SBICs, venture capital and private equity firms located throughout the United States. Our clients have invested at all stages of development of portfolio companies, including seed and early stage, growth, mezzanine and buyouts. Clients have invested across all industry sectors, including e-commerce, biotechnology, health, telecommunications, information technology, manufacturing, distribution, outsourcing, publishing and retail. Portfolio companies are both privately held and publicly traded. Several of our clients sponsor or have relationships with incubators/accelerators. Pepper Hamilton has an extensive merger and acquisition practice and is accustomed to regularly representing buyout as well as venture capital investors.

### **Counsel to Portfolio Companies**

We are experienced in all aspects of representing portfolio companies. We have helped companies grow from their initial incorporation and negotiation of their initial small contracts into large multi-national businesses. We advise growing businesses with respect to strategic alliances, technology licenses, incentive compensation plans, protection of intellectual property, personnel matters, securities compliance, relationships with suppliers and customers, banking and other financial relationships, and creditor rights matters. We have a large securities practice that handles public offerings on behalf of issuers and underwriters.

### **Support of the SBIC Industry**

Pepper Hamilton has been a member of the Small Business Investment Alliance (SBIA) since 1981, and has provided extensive support and counsel to the industry. Our lawyers have worked closely with SBIA and the U.S. Small Business Administration to assist in developing regulations and SBA policies implementing the “new” SBIC program in 1992 and to constantly improve the program. The firm has helped SBA develop several of its form documents and has helped SBIA prepare a number of its legislative and regulatory initiatives. The firm continues to provide advice and counsel to industry leaders as changes to the SBIC Program are discussed.

Pepper Hamilton has sponsored and helped organize numerous seminars on the formation and operation of SBICs. Members of the firm are frequent speakers concerning the SBIC program at industry meetings and the SBIA Venture Capital Institute, as well as at gatherings of prospective investors, accountants, lawyers, development officials, venture capitalists and businesspeople. Our lawyers regularly meet with SBIA and SBA officials concerning industry policies and practices.

### **Practice Group Members**

Pepper Hamilton’s SBIC Practice Group is led by Michael B. Staebler (Detroit and Washington, D.C.). Mike served for six years as president and CEO of an SBIC located in Ann Arbor, Michigan (prior to its sale to NBD Bancorp (now JP Morgan Chase) and has

represented numerous SBICs and venture capital firms since 1972. He has authored several articles describing the formation and operation of SBICs, has served on SBA’s Advisory Counsel and has chaired the SBIC subcommittee of the American Bar Association.

Other members of Pepper Hamilton’s SBIC Practice Group include Vicki R. Harding, Michael A. Temple and Janet L. Beyer (SBIC Project Administrator) (Detroit); Chris Rossi (Berwyn); Julia D. Corelli, Greg Nowak, Bradley Boericke, Joseph V. Del Raso and Lisa B. Petkun, (Philadelphia); and Hugh D. Camitta and Todd W. Betke (Washington, DC).

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