

**House of Representatives Committee on Small Business  
March 13, 2008  
“A Hearing to Review Legislation to Re-authorize the  
Small Business Innovative Research (SBIR) Program”**

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Final**

**Introduction**

Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee, my name is Mark Heesen and I am president of the National Venture Capital Association (NVCA). The NVCA represents more than 480 venture capital firms in the United States and advocates for policies and legislation that are favorable to American innovation and entrepreneurship. In 2007, venture capitalists invested approximately \$30 billion into small, high-risk, emerging growth companies in areas such as life sciences, information technology, homeland security, and clean technology. The goal of our members is simple – to bring the best and most innovative new products and services to market in the most efficient manner.

I would like to thank the Committee for the opportunity to contribute to the discussion regarding the reauthorization of the SBIR program which expires in September. I hope my comments today will effectively capture the NVCA’s unwavering support for the draft Committee Print, which includes a provision that will allow small businesses backed by professional venture capital investors to once again participate in the SBIR program. When put together, SBIR funding and venture capital investment is a proven and effective way to bring a steady stream of innovation to the market and support small businesses.

Yet, it is important to articulate the venture capital industry’s utmost frustration with the Administration’s campaign to exclude small, venture-backed companies in this important program. These are among the most talent-rich entities in the United States and they are focused on solving very important problems. To preclude them is a disservice to our country. To that end, if the provisions which guarantee a level playing field for venture-backed companies are removed or

compromised in any way, NVCA will not support the re-authorization of this program. The program can not continue to precisely exclude the small businesses that offer the most promise in assisting the government in commercializing truly innovative technologies. In this extremely budget conscious environment, the appropriateness of such a program under such circumstances can and should be questioned.

With the reauthorization of the SBIR program, Congress has the opportunity to correct a significant injustice that has gone on too long. It has been seven years since an administrative law judge redefined an “individual investor” to mean a “natural person,” thereby opening the door for the Administration to exclude from the SBIR program small businesses that have received venture capital funding. While there has never been an actual change in law or regulation, the Small Business Administration (SBA) has used this interpretation in recent years to deny grants to many of our country’s most worthy small businesses. Over the last seven years SBA’s policies regarding SBIR eligibility and how they determine if an entity qualifies as a small business have been inconsistent, discriminatory, and based on serious misconceptions which they appear to have absolutely no interest in re-examining.

In contrast to the SBA, we believe that the best use of government dollars is to leverage public / private partnerships in which we all have a role in bringing innovation out of the garages, labs and tiny businesses and into the marketplace, into the healthcare system, into our military and into developing alternative energy. The venture capital community is committed to contributing significantly to this endeavor. We have consistently asked the Administration to join us. In absence of their willingness to work with us, we urge Congress to reauthorize the program with provisions that ensure venture-backed companies have a fair chance to thrive under the SBIR program alongside of their non-venture-backed counterparts. Doing so will only strengthen the future success of the program.

### **Venture-Backed Companies are Small, Fragile Businesses**

I would like to spend some time debunking the myths employed by the SBA when they argue against venture-backed business participation in SBIR programs. The first myth is that venture-backed companies do not need SBIR programs because they are strong, fully funded entities. Make no mistake: the venture-backed companies that apply for SBIR grants are the epitome of small, fragile

businesses. These entities typically employ less than 25 people, and are comprised of just a few individuals who have developed a promising innovation that they wish to bring to market. Like all small businesses, they face many obstacles unique to young innovators including clinical trials and beta tests, regulatory approvals, competition from larger players, human capital needs, and, of course, financing. The only distinction for a venture-backed company is that it has demonstrated enough promise to attract an investor whose business it is to find and fund opportunities ready for commercialization.

Even with venture capital investment, the road is long and difficult. These companies are extremely high risk and have the same chance of failure as their non-ventured counterparts. Contrary to the SBA's premise, venture-backed companies do not have access to a bottomless pit of funds. In fact, the financial controls at a venture-backed company are perhaps more stringent than those without this oversight. Venture dollars are earmarked for very specific development activities. They are focused on exclusive projects with narrow trajectories. Venture-backed companies must also consistently meet or beat agreed upon milestones to continue to receive funding. Perhaps SBA believes venture funded companies have unlimited cash because they believe venture firms have unlimited cash. That too is a fallacy. Venture firms raise capital in a closed-end process. Once the fundraising cycle is complete, venture firms have a contractually finite pool of resources with which to help grow a dozen or more companies—and those resources have to last 10-12 years.

When a small business receives venture capital, there are no “extra” funds to support early stage basic research projects. Venture capital dollars are not available to these companies for this purpose. Venture capitalists support applied research and commercialization. Small venture-backed companies are also extremely unlikely to win government R&D dollars, which are targeted to specific programs and large corporations. To wit, only 0.4 percent of the NIH extramural grants went to businesses with most monies directed to higher education and research institutions. Just last week this Committee heard compelling testimony from small businesses across various industries about the difficulty they face in competing for government procurement dollars. For many venture-backed companies, the SBIR program is their only funding mechanism for critical early stage projects. Both venture capitalists and entrepreneurs by their very nature are opportunity seekers. If there were other avenues to obtain these much needed funds, after seven years of being discriminated against by the SBA, they would have found it by now.

## Venture Capital Firms are Not Large Corporations

The SBA also wrongly assumes that venture capital firms are equivalent to large corporations, and therefore the companies that they fund should be excluded from consideration from SBIR grants. On September 6, 2007 Steve Preston, SBA Administrator, testified before the House Small Business Committee, where SBA went on the record opposing a provision in HR 3567 that would include venture-backed companies stating that, *“While SBA encourages venture capital investment in small business we must object to this provision. The basic premise of small business size status (independent ownership and control) is circumvented by this provision, which would allow a **large business** (emphasis added) to own and control several small businesses without affecting the size status of the businesses.”*

We agree that large corporate owned businesses should not be allowed to participate in small business programs. But venture capital firms are not large corporations with deep pockets and ulterior motives. They are almost entirely private partnerships that are typically comprised of less than a dozen professionals. And if the SBA considers a dozen professionals to be equivalent to a large corporation, then almost every business they support is out of compliance.

In reality, the SBA knows this, which is why they have gone to great lengths to manipulate the system and concoct a nonsensical formula to justify their position. In September of 2007, one of our members testified before this Committee and described a situation in which one of its small portfolio companies was denied a small business waiver from the SBA for a \$900,000 FDA application fee. While the company employed just 7 people, the SBA affiliated every employee from not only the venture capital firm (in which there were less than 10) but also every company in the venture portfolio, to exceed the 500 employee threshold. Aside from this maneuver being absolutely irrational and unjustified, the SBA hurt a very small business and delayed a very promising drug discovery.

H.R.3567, the Small Business Investment Act, which passed the House with an overwhelming bipartisan margin, incorporates the appropriate safeguards to ensure large corporations cannot participate in small business programs. The draft Committee Print to Reauthorize the SBIR incorporates the same safeguards. By definition and practice, venture capitalists are financial investors who share the same goal as the SBIR program, i.e., the desire to generate successful small

business innovation and build these small businesses to stand on their own. Venture capital firms are small businesses growing small businesses.

### **Venture Backed Companies are not Controlled by Venture Capitalists**

The SBA also wrongly assumes that venture backed companies are controlled by venture capitalists. While venture capitalists as investors typically have Board participation (usually two or three seats of a five to seven member Board), they do not exert day-to-day control of a company for several reasons. The partners at venture funds work with a number of portfolio companies at once. Their time is divided between all investments of the venture fund and it would be impossible and impractical to spend that limited time on the nitty-gritty, day-to-day decisions that the internal management team must make instead of helping the management team make the strategic level decisions necessary to grow. Unlike corporations, venture capitalists are usually limited life entities that make their return on investment only when the portfolio company is sold or makes a public offering of its securities. And lastly, more often than not, the venture capital firm does not have controlling interest. The 51 percent or more ownership of a company is often achieved because there are several venture firms invested, giving each a smaller, more diluted share in the company.

Ironically, SBA's policy particularly hurts the very regions that the SBIR program was designed to support, like mid-America where only about four percent of all venture capital is invested. The scarce venture capital dollars available in this region must cover a greater geographic footprint than the concentrated areas such as Boston or the San Francisco Bay area. For this reason, venture funds generally join together to fund a promising start-up, as a single firm indigenous to the region will not have the capital to fund a company fully. As each firm takes an equity stake in the company, the total venture ownership percentage can quickly rise above the 51 percent threshold, thereby making the mid-America start-up company ineligible to apply for an SBIR grant.

### **SBIR and VC Have Worked Well Together**

In discriminating against venture-backed companies, the SBA has tried to "fix" a situation that was never broken. Throughout the SBIR program's history, and prior to the current controversy, majority venture-owned small business have applied for and received SBIR funding. This historical precedence strongly suggests that their participation has caused no harm to the program or to other

small businesses. To wit, the recent National Academies of Sciences study on the SBIR program offered no evidence that other small businesses have ever been crowded out by the participation of venture-backed businesses.

The NAS report also found that there are useful synergies between venture capital investment and SBIR funding in terms of selecting the most promising companies. During the first two decades of the program, when participation of venture funded firms was not at issue, some of the most successful NIH SBIR award winning firms were able to perform at high levels because they were allowed to receive venture funding as well as SBIR awards. By discriminating against venture-backed firms, the SBA is removing some of the most worthy applicants from consideration. This behavior isn't helping anyone and, in fact, is hurting many.

### **The Current Situation is Untenable**

Venture-backed businesses have been fighting this battle for too long. And many of the best have already given up on the promise of SBIR and for good reason. They are being put in a position of choosing one type of investment over the other – when, in reality they need both. It is a terrible message to send to small businesses and innovators.

Given the extreme actions of the SBA, it is very difficult under current circumstances for small venture-backed businesses to understand the rules of the game. In fact, SBA's policies have become so inconsistent and unpredictable that top law firms have sent out advisories to clients warning them of the perils created by the SBA. In January of this year, Cooley Godward Kronish published an alert to clients saying that there is a significant risk for venture-backed companies to participate in the SBIR program under the False Claims Act. This law firm is one of the top legal advisors to venture-backed start ups and they are broadcasting to the venture capital and entrepreneurial community that there are now legal liabilities associated with the brightest companies seeking government funding.

### **A Public/Private Effort is in Everyone's Best Interest**

The SBA's discriminatory policies have seriously negated the positive impact of venture-backed small businesses on innovation. Both venture dollars and SBIR dollars play complementary roles in

financing innovation. One is rarely if ever a substitute for the other. Venture-backed companies seek SBIR dollars because they are needed to help finance innovations that are too early in their development for the venture capitalists to cover. SBA is cutting off the innovation pipeline so the most promising projects never see the light of day – and it is denying our government scientists the opportunity to collaborate with some of the most talented private sector engineers and researchers in the world.

If it is still the intent of Congress that the SBIR program generates significant commercial impact, it makes no sense to exclude any class of venture-backed small businesses because they are empirically among those most likely to have significant commercial success. New technologies developed by venture-backed small businesses are a critical source of innovation essential to accomplishing the missions of NIH, DoD and more recently the interest within the Department of Energy to work with the venture capital industry to develop alternative energy sources. Excluding such business from SBIR participation will do nothing to help advance the goals of these agencies at a time when we need as much access to innovation as possible to solve serious issues around homeland security, energy dependence, and quality healthcare.

Case in point: the Department of Defense (DoD) Office on Innovation recently concluded that the SBIR program could have the additional benefit of being a mechanism to provide early access to venture-backed technologies the government wouldn't see otherwise. Programs such as the Defense Venture Catalyst Initiative (DeVenCI) focus on increasing DoD awareness of emerging commercial technologies developed by non-traditional DoD procurement sources. During this process, the DoD may come across a promising venture-backed technology that could solve a significant national security challenge. However, the technology may require additional research that a venture capital firm can not afford but the SBIR program could. Yet the SBA's policy would preclude an SBIR grant and deny government access to cutting edge technologies. These technologies exist across all the areas that venture capitalists invest -- life sciences, information technology and alternative energy. Yet, without SBIR support, these projects will not take place and will never be developed to the point that the government or general public can use them.

## **Conclusion**

The venture capital industry is known for its patience when it comes to investing. And as an industry we have been extremely patient as the problems I've recounted are brought up again and again. We are extremely appreciative of the lawmakers who support the inclusion of venture-backed businesses in the SBIR program. But we have lost a great deal of time and innovation in the last seven years as we have allowed the Administration to discriminate against an entire subset of promising candidates – simply because others think they are promising too. In the mind of the SBA, venture backed companies should be penalized for succeeding. The SBIR program is a wonderful mechanism for the government and private sector to come together and do what everyone in this room wants us to do – innovate! We are asking Congress and the SBA to let us do just that. We support this bill and reauthorization wholeheartedly but only if we have an opportunity to contribute to its success. With venture capital working with government we have nothing to lose and everything to gain.

Thank you for your time.