U.S. Small Business Administration
Statement of Administrator Steven C. Preston
House Small Business Committee
Reauthorization of the Small Business Innovation Research Program
March 13, 2008

Chairwoman Velazquez, Ranking Member Chabot and members of the Committee, the Small Business Innovation Research (SBIR) Program has helped small business to access federal research and development funding.

The SBIR Program was created in 1982 and has been used by small firms to fund research that has fostered technological innovation and commercialization of products. Every federal department with an extramural research and development budget of $100 million or more participates in the SBIR Program. There are currently eleven federal departments that participate including Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, Homeland Security, Transportation, the Environmental Protection Agency, NASA and the National Science Foundation. SBA is responsible for promulgating regulations and policy directives to govern the program, while other federal agencies utilize the program to foster innovation.

Eligibility Rules

As a brief background, for a business to be eligible for participation in the SBIR Program, on the date of award they must (1) be organized for profit; (2) be at least 51 percent owned and controlled by one or more individuals who are citizens of, or permanent resident aliens in, the United States or at least 51 percent owned and controlled by one other for-profit business that is itself at least 51 percent owned and controlled by individuals who are citizens of, or permanent resident aliens in, the United States; and (3) have, including its affiliates, not more than 500 employees. The purpose of these requirements is to ensure that benefits reach only the small business entrepreneurs and that the research and development advances resulting from the SBIR Program remain in this country and benefit the United States.

In 2003, SBA proposed a rulemaking to modify the ownership requirement for SBIR awardees. The Proposed Rule was to add a specific flexibility in the requirements to allow SBIR awardees the option of conducting their innovative SBIR work through a wholly owned and controlled subsidiary. Cases had been brought to SBA's attention where small businesses formed research and development subsidiaries to pursue innovative research with SBIR funding. However, the subsidiaries were unable to receive the funds directly because they were more than 49 percent owned and controlled by another firm. The Proposed Rule was open to public comment from June 4, 2003 to July 7, 2003. Most of the comments were in favor of the proposed change. Some comments argued that the rule need not require 100 percent ownership and control—that less than 100 percent ownership and control by another concern should be allowed.

After reviewing the public comments, SBA published a Final Rule on this issue in the Federal Register on December 3, 2004 (69 FR 70180). In the Final Rule, SBA made one modification to the ownership requirement set forth in the Proposed Rule. It changed the proposed requirement that the subsidiary be 100 percent owned and controlled by another for-profit business to the requirement that it be at least 51 percent owned and controlled by another for-profit business. Based upon the comments received, the SBA considered its original proposal to be unnecessarily limiting. The Final Rule therefore provides that an SBIR awardee must meet the following requirements: it must be either (1) a for-profit business concern that is at least 51 percent owned and controlled by one or more individuals who are citizens of, or permanent resident aliens in, the United States (as the pre-existing regulations required); or (2) a for-profit business concern that is at least 51 percent owned and controlled by another for-profit business that is itself 51 percent owned and controlled by individuals who are citizens of, or permanent resident aliens in, the United States. The Final Rule became effective January 3, 2005.

During the period that SBA was developing the proposed rule, SBA's Office of Hearings and Appeals (OHA) received an appeal from a company that was found ineligible for the SBIR Program because it was not majority owned by individuals. During the appeal it was argued that the term "individual" in the program's 51 percent ownership requirement should be interpreted to include non-corporate institutional investors such as Venture Capital Companies (VCCs). On May 29, 2003, OHA denied the appeal maintaining the long-standing interpretation that an "individual" is a natural person. This decision reaffirms the eligibility requirements set forth for the SBIR Program.

The 51 percent requirement is there to distinguish between individual owners and owners that are institutional entities to ensure that SBIR funds go only to small, independent U.S. firms. It is important to note that the OHA decision constituted neither a new eligibility rule, nor a new restriction on venture capital financing within the SBIR Program. In fact, based on the new final rule SBA believes this provides further opportunities for venture capital involvement under the SBIR program.

Venture Capital Participation

SBA wants to ensure that the integrity of the program is maintained and that it remains a program for small businesses. VC participation has been allowed and encouraged since the inception of the program. Currently, more than one venture capital company may invest any amount of money into small businesses that receive SBIR awards, with the only restriction that they cannot in concert own more than 49 percent and/or have the ability to control the SBIR awardee. In addition, if a VCC is for profit and is owned at least 51 percent by one or more individuals who are U.S. citizens or permanent resident aliens, it may own more than 49 percent of the SBIR awardee so long as the awardee and its affiliates (including the VCC and its affiliates) have no more than 500 employees in total.

The option of expanding VCC participation raises a number of issues. For example, exempting VC or other institutional investors from affiliation in size determination could affect the transparency needed to determine program eligibility as well as the intent of the program to benefit businesses that are small. Further, any changes to SBA's size standards could potentially affect SBA's other programs. SBA is unaware of any meaningful distinction between VCCs and other business entities that would allow greater VCC participation in the SBIR program without affecting important ownership restrictions in other SBA programs.

SBA is particularly concerned with possible changes to its affiliation provision. Affiliation is a key concept in defining a small business. Along with a numerical measure of the size of business, the Small Business Act includes the criteria that a small business must also be "independently owned and operated." Without a consideration of affiliation, Federal assistance targeted for small businesses could be inappropriately provided to a business concern that is part of a large business. Accordingly, SBA advises Congress to proceed with the utmost caution in this key concept of defining a small business.

Proposed Legislation

The Administration is concerned with the proposed legislative change to the definition of small business for the purposes of venture capital investment. While recognizing that venture capital investment is crucial to small business growth, the Administration is nevertheless concerned that the committee print offers too broad a definitional change to the affiliation standards. SBA is currently reviewing these rules, and believes that the current change may not reflect the appropriate balancing required in development of size standards. In particular, any redefinition that alters the elements of independent ownership and control that identify small business ownership under current law has the potential for great harm to all small business programs.

It is also of concern that there are certain potential conflicts in the proposed legislation. For instance, SBA has noticed that there is a conflict between the definition of a VCOC which includes patent and licensing organizations affiliated with institutions of higher education and the clause requiring that VCOCs not be controlled by any business concern that is not a small business concern. Under the Small Business Act institutions of higher education are generally not considered small business concerns. Such definitional conflicts present potential inequities and SBA would hope we could work with the committee to clarify this language, consistent with what we believe is a mutual overarching objective: appropriately define the term "small business" in a manner that effectively minimizes *ineligibility* of actual small businesses while also minimizing the *eligibility* of large businesses.

Despite our differences of opinion on the affiliation rules, SBA is committed to the continued improvement and expanded monitoring of the SBIR program. In particular, the Administration would like to work with the committee to create performance goals for the program. These goals and metrics will provide useful information on the successes and strengths and weaknesses of the program in its goal to support innovative research.

For example, the Administration would like to develop quality metrics that can assist agencies in developing standards to limit the perceived effect of so-called “SBIR mills”. In order to understand the issue surrounding multiple award winners it is necessary to have clear data on the issue. Successful awardees should not be penalized provided there is a solid basis for their awards and a clear understanding of the nature of the research’s potential for advancement.

Likewise, the Administration would support efforts to study the commercialization and implementation of research to develop a better understanding of the needs of the Phase III process. While recognizing the historic goal of commercialization in the SBIR program, we believe that further expenditures and programmatic changes should be based on performance data, and we caution Congress to avoid re-focusing the program in a manner that involves direct support for commercialization activities more appropriately performed by the private sector.

The Administration’s clear goal is to further quality research which produces significant results for the Nation. SBA looks forward to working with this Committee as legislation moves forward prior to the sunset date on September 30, 2008.

I appreciate the opportunity to share the administration’s position on the SBIR programs and I look forward to answering any questions you may have.