Small Business Technology Council

December 12, 2012

Edsel Brown, Jr.
Assistant Director, Office of Innovation
Small Business Administration
409 Third Street SW
Washington, DC 20416

Dear Mr. Brown,

The SBA recently issued new rules setting transition rate benchmarks for Phase I to Phase II awards. Under the new rule, SBIR firms would be required to maintain a ratio of one Phase II award for every 4 Phase I awards from a particular agency over a 5, 10 or 15 year average in order to remain eligible for any additional Phase I awards.[1]

The Small Business Technology Council believes that these new transition rules are overly strict and rigid, and could result in a number of good companies being driven out of the program. The 25% Phase II conversion hurdle is dysfunctionally high and will lead to less innovation. The purpose of Phase I is to be risky – to test a potentially-transformational concept, with government reviewers choosing the proposals they believe have the greatest potential to achieve this. By nature, Phase Is should contain most of the risk in an SBIR project: high risk with uncertain outcome, or there would be no need for Federal investment. The point of the Phase I is to reduce technical risk in the concept, to prove that the concept is technically viable and beneficially attractive, and likely to succeed in Phase II.

With overall Phase II conversion rates in the low 40% range historically, normal deviation especially in small numbers can easily drop to 25% with no fault on the company's part: too many Phase Is awarded, lack of agency interest in the topic, changes in agency focus, or even excellent agency selection choices that led to a rich and highly competitive field of Phase II candidates are all common situations that could lead to SBIR companies falling below the 25% benchmark. A too-high required conversion from Phase I will lead to the program supporting increasingly risk-averse opportunities.

To place a 25% Phase II conversion hurdle is to tell companies to make sure they do not undertake risky Phase Is, to instead propose only projects that have a high chance of winning a Phase II. This is contrary to the purpose of the SBIR program, and will lead to fewer innovative proposals. Also, as companies that are newer to the program progress to Phase II at lower rates, this will also place a higher burden on newer entrants to the program, further reducing innovation from new participants.

Even assuming government reviewers choose the less-risky Phase Is, a benchmark of 25% is a very strict level to meet for all companies across all agencies of government. There are different Phase II transition

[1] http://www.gpo.gov/fdsys/pkg/FR-2012-10-16/pdf/2012-25314.pdf

rates in different technology sectors, meaning this rule could unfairly target companies in riskier, more experimental sectors where there is a lower level of success at the proof-of-concept stage of development. Each agency makes decisions regarding its Phase II program differently, for example the NIH makes several jumbo-sized and concurrent Phase II awards, reducing the number of awards it can give out and making them subsequently harder to win.

In addition to reducing innovation, excluding a company from participating in the SBIR program for failing to meet the proposed Phase II conversion benchmarks will prove to be unduly burdensome on more innovative small businesses given the current financial climate. Banks have removed over $100 billion from the small business lending market over the last 3 years, making it extremely difficult for small businesses to secure financing.[2] Venture capitalist investment also has continued to fall, down 12% from last year so far, with early and seed stage deals receiving the biggest decline in investment.[3] Without the possibility of SBIR funding for a year, many innovative companies could be forced to go out of business.

Many of our members question the need for transition benchmarks at all. There are no known studies that show that firms who achieve less than a 25% ratio of phase I's to phase II's are not valuable contributors of technology for those programs that are successful. Rather, the National Academy study showed the program to be working well. Firms are naturally motivated to achieve Phase II awards since these provide much larger funding for projects, a benchmark rate is not needed for incentive. Ideally, it would be preferable to understand the reasons for the ratio of Phase I to Phase II rates within different agencies before an arbitrary benchmark is established that will be detrimental to the objectives of the SBIR program.

The SBTC recognizes that the new SBIR reauthorization language requires agencies to set transition benchmarks to encourage technology development and discourage waste, fraud, and abuse, but we believe the current proposed benchmark are too onerous. We recommend reducing the benchmark to 10%. This will provide SBIR companies with a greater margin for risk-taking, while still eliminating any companies that aren't transitioning their Phase I technologies to Phase II.

We also note that the Policy Directive specified that these benchmarks are only meant to apply to companies that have won a specified threshold number of Phase Is, and so recommend that the SBA clarify that these benchmarks are meant to apply only to companies that have won 20 or more Phase I proposals from a specific agency in the benchmarked time period.

Sincerely,

Jere W. Glover

Jere W. Glover
Executive Director
Small Business Technology Council

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[2] http://www.sba.gov/advocacy/7540/173967
[3] http://techcrunch.com/2012/10/18/vcs-put-6-5b-in-890-companies-in-q3-2012-total-dollars-and-deal-volume-both-down/