July 16, 2012

VIA FIRST CLASS AND ELECTRONIC MAIL

Mr. Carl Jordan
Office of Size Standards
Mr. Edsel Brown, Assistant Director
Office of Technology
U. S. Small Business Administration
409 Third Street SW
Washington, D. C. 20416

Re: Small Business Size Regulations, SBIR and STTR programs – Federal Register Vol. 77, No. 94 – 5/15/12

Dear Messrs Jordan and Brown:

In response to the Small Business Administration's (SBA) request for comments on its proposed size regulations for the SBIR and the STTR program, the Small Business Technology Council (SBTC) submits the following comments. These comments are endorsed and supported by the National Small Business Association (NSBA), the California Small Business Association, Small Business California, the Small Business Association of New England (SBANE), the New England Innovation Alliance (NEIA), SAVE SBIR, The SBIR Coach, and the SBIR Resource Center.

BACKGROUND

The Small Business Technology Council is a non-partisan, non-profit industry association of companies dedicated to promoting the creation and growth of research-intensive, technology-based U. S. small business.

SBTC encourages the promotion and growth of these U. S. small businesses. Through advocacy and education SBTC applies the collective wisdom of its board to guide the future of small business in the technology sector.

Its mission is closely aligned with the statutory objectives of the SBIR and the STTR programs. Therefore SBTC and its members have a direct interest in the SBA proposals which, by congressional mandate, are to preserve and maintain "…the integrity of the SBIR program as a program for small business concerns in the United States by prohibiting large businesses or large entities or foreign-owned entities from participation in the program…" (Small Business Reauthorization Act of 2011)

The SBIR/STTR programs are the most successful R&D programs in the world. 25% of the key innovations come from this small 2 1/2-3% of federal extramural expenditures.[1]

INTRODUCTION

As for the current initiative, by Congressional mandate, SBA is to determine the conditions under which small business concerns that are majority-owned by venture capital operating companies, hedge funds, or private equity firms may be eligible to participate in the SBIR program. It must do so, however, in a manner consistent with its lynchpin mission under the *Small Business Act*, namely to promote the interests of small business in order to "…strengthen the overall economy of the Nation." It can be assumed that "Nation" means the United States.

It must also do so in compliance with Congress' directive to preserve the "…integrity of the SBIR program for small business concerns in the Unites States…"

Thus the overriding issue is whether SBA's proposals regarding eligibility for participation in the SBIR program by venture capital entities, etc. ensure that large businesses or large entities or foreign-owned entities *cannot* participate in the SBIR program in accordance with the following Congressional mandate:

> (1) STATEMENT OF CONGRESSIONAL INTENT
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> It is the stated intent of Congress that the Administrator should promulgate regulations to carry out (C) **preserve and maintain the integrity of the SBIR program as a program for small business concerns in the United States** by **prohibiting large businesses or large entities or foreign-owned businesses or foreign-owned entities** from participation in the program established under section 9 of the Small Business Act. (emphasis added)

See Sec. 5107 (c)(3)(ii) Small Business Reauthorization Act of 2011.

Pursuant to Congress' directive, the Administrator must promulgate regulations to preserve "…the program for **small business concerns in the United States** by prohibiting large businesses or large entities or **foreign-owned businesses or foreign-owned entities**. " However, nowhere in the proposed regulations does SBA explain how its proposals would prohibit foreign "owned" business or entities from participating in the SBIR program.

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[1] Universities and Fortune 500 firms together account for less than 20% of all key innovations in the U.S.Fred Block and Matthew Keller, Where Do Innovations Come From? Transformations in the U.S. National Innovation System 1970-2006, Information Technology and Innovation Foundation, July 2008.

As will become apparent in SBTC's comments to follow, SBA's proposals do not comply with "Congressional intent" quoted above. SBA has chosen instead to propose regulations that will in effect allow foreign owned business, large businesses or large entities to compete in the SBIR program through a device of creating a small business entity incorporated in the United States that is wholly or majority owned or controlled by them.

SBTC's comments follow SBA's requests for comments in its Federal Register notice of 5/15/12.

COMMENTS

I. *"SBA welcomes comments on whether the proposed definition of domestic business concern should include additional criteria to ensure that the business is truly a domestic concern…" SBA further states that its proposal "simplifies and streamlines the current ownership and affiliation criteria for the ownership and affiliation criteria for the programs while also ensuring that only domestic small businesses receive the benefits of these programs."*

SBA's assertion that its proposal "simplifies and streamlines" its definition is simply that, an assertion without any evidence of simplification or streamlining. In fact SBTC contends that SBA's definition of "domestic business concerns" has no requirement that these new entrants into the SBIR/STTR program be in fact "domestic," meaning U.S. owned. SBA proposes only that the concern "…has a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S, economy through the payment of taxes, or use of American products, materials or labor. [2] SBA further adds that the concern must be "…created or organized in the United States, or under the law of the United Sates or of any State." Purportedly this is intended to further define "domestic."

Instead of focusing on ownership, SBA proposes to use the above definition in which the only test is where a company chooses to file its incorporation papers. Any foreign company or individual can go on the Internet and file incorporation papers and, by doing so, meet the new standard that it be "organized in the United States."

This change is a radical departure from the current ownership requirement that to be SBIR eligible the company must be 50+% owned by US citizens or permanent resident aliens. SBA offers no explanation for the departure even though the

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[2] SBA current policy directive for SBIR and STTR require that the research be done in the U.S. By complying with this requirement, any foreign entity meets the contribution test. The filing of incorporation fee on the internet is $49. The tests proposed by SBA are so weak that any foreign entity can easily and inexpensively participate in the SBIR/STTR program under the new rules. U.S. taxpayers shouldn't be paying foreign companies to create jobs overseas.

Reauthorization Act suggests that its criteria should consider whether an applicant should be at least 51% owned or controlled by citizens of the U.S. and whether an applicant is domiciled in the U.S.

Particularly troubling is the fact that this new proposal affords the US taxpayer little assurance that the technology will create US jobs, or helps the US economy. (Reference SBA's obligation quoted above to "…strengthen the economy of the Nation.") Without appropriate safeguards against foreign ownership, this definition opens up hundreds of millions of SBIR/STTR dollars to companies that are foreign owned, companies that could take the technology paid for by US taxpayers to other countries for commercialization and job creation and thus fail to support U.S. interests. *This is indefensible.*

And this is particularly indefensible given what we know about foreign interest in the SBIR program. Foreign interest is not mere speculation.

*Two VC firms owning a company thought to be eligible for the SBIR program could not compete because the company was majority owned by a foreign firm. (AIG's Swiss venture capital subsidiary and a Canadian verdure capital company owned a majority interest in a company that SBA determined was ineligible to compete in the SBIR program.) It can be assumed that VC firms will look for any opportunity to garner funds for their investments.[3] Where Many more attempts by foreign companies can be expected.

*Ten foreign governments have copied the SBIR program and would see an opportunity to expand their program by entering the US SBIR program.

*Foreign governments have cut back on their R&D expenditures and it should be anticipated that they will be looking for any funding opportunities to advance their interests.

*The SBIR budget of 2 ½ billion dollars is a treasure trove for foreign companies to try to penetrate. If allowed to penetrate, the overall impact on the U. S. economy will be diminished, thwarting the intent of the SBIR program to invest in the U. S.

Stated simply, SBA's definition contains loopholes that would allow otherwise *ineligible* entities seeking entry to the SBIR program to do so successfully. It is ambiguous at best and questionable that it carries out the intent of the SBIR program that it be a program for "small business concerns in the United States."

II. *SBA welcomes comments (1) whether the eligibility criteria meets [sic] the statutory purpose of the programs with respect to domestic ownership of the applicant (2) whether eligibility criteria meets [sic] the statutory purpose of the program with respect to ownership by other than small businesses; and (3)*

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[3] *Size Appeal of Cognetix, Inc.*, SBA No. SIZ-4560 (2003)

whether the proposed rule should address other issues besides the above with respect to ownership."

SBTC's preceding comments expressly state that (1) the proposal does not clearly address the issue of domestic ownership, and (2) the proposal contains loopholes that would allow large and foreign-owned entities to compete for SBIR and STTR funds.

As for (3) –"other ownership issues," one issue that is not addressed in the regulation is how SBA will determine if a venture capital company is foreign owned. Venture capital firms incorporated in the U.S. could have investor groups that are foreign owned. In fact, they could be solely owned by a single foreign investor or a group of investors without any American ownership. Yet there is no provision in SBA's proposed regulations requiring VCs to disclose the ownership of its investor groups.

<u>This has significant national security implications</u>.

To illustrate: Countries that are our adversaries could use the SBA rules to seek information on mission-critical technology development for defense and other US Government applications by forming entities that invest in, or create, US-based companies for the purpose of winning SBIR grants and thus gather information that the Department of Defense would not want them to have. Moreover, given the fact that many SBIR programs contain sensitive and cutting edge technology, it would greatly increase risk of military sensitive technologies being shared or transitioned to unfriendly nations.

And high quality jobs created there under would flow to serve foreign interests and the interests of foreign owners, not the U.S. economy.

SBA needs to understand and deal with this issue because this would affect about half of the nationwide SBIR programs. There is no reason why VC funds that participate in SBIR under the new rules should not be required to do a US percentage calculation to determine if the SBIR applicant is foreign owned or controlled.

SBTC believes that SBA should retain its longstanding criterion that, to be SBIR eligible, the company must be 50+% owned by U. S. citizens or permanent resident aliens. The Department of Defense threshold only allows ownership of 5-10% ownership or voting power for some purposes. Involving sensitive information [4,5,6,7] SBTC believes that the foreign ownership percentage should be reduced to no more than 25% to make that only domestically owned entities can compete in the program.

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4 http://www.dtic.mil/whs/directives/infomgt/forms/eforms/sf0328.pdf

5 http://www.dss.mil/isp/foci/foci_faqs.html

6 http://www.dss.mil/isp/foci/foci_info.html

7 http://www.dss.mil/documents/odaa/nispom2006-5220.pdf

This 50% ownership criterion has been a time-tested requirement. It is simple. It is clear. It is not susceptible to misinterpretation. The burden of having a company check to see if it is owned directly or indirectly by U.S. citizens or resident aliens is not great compared to the benefit of receiving millions of dollars in precious research and development funds. There is no right to do business with the Federal government.

III. *Comments on the 500 employee size standard.*

SBTC concurs with SBA's decision to retain the 500 employee size standard.

That said, SBTC believes that a substantive evaluation of the size standard is in order rather than it being justified as being the same standard for two research and development industry size standards (NAICS 541711, Research and Development in Biotechnology and NAICS 541712, Research and Development in the Physical, Engineering and Life Sciences). SBA is encouraged to review the SBIR/STTR 500 employee size standards as part of its comprehensive size standard review at the time it reviews the size standard for NAICS codes 541711 and 541712.

IV. *SBA welcomes comments on whether it should : (1) retain the current affiliation rule with respect to minority stock holdings and, if so, whether it should set forth a specific threshold by which it will find control and therefore affiliation (e.g. if a person owns 33% or more of the company) in order to create a bright-line test for applicants; (2) find affiliation if two or three persons or businesses collectively own more than 50% of the applicant, and the same two or three persons or businesses collectively own more than 50% of any other company or entity; or (3) implement a rule setting forth both options (1) and (2) above.*

SBA further requests comments whether the proposed rules sufficiently prevent other than small businesses from controlling SBIR and STTR applicants and any other issues related to affiliation not addressed by the proposed rule.

The proposed rules eliminate affiliation tests for large minority shareholders, an exception made for the SBIR program only. This expands eligibility to firms that are not eligible for other SBA programs. Why?

Existing rules are designed to determine if an applicant is indeed a small business. SBA's proposal changes the rules' focus from stock ownership, currently used to determine affiliation, to the location where a company chooses to file incorporation papers without regard to identifying actual ownership, making it virtually impossible to determine if concerns majority owned by venture capital companies, etc. are in fact small businesses.

The rules that are being proposed for SBIR/STTR programs only measure whether a firm's affiliation with other entities preserve an applicant's status as small business shift the focus away from an "ownership" standard to "who controls the board of directors."

This is a loophole that would allow large firms which are affiliated with an SBIR applicant to participate in the SBIR program simply because they did not control the applicant's board. Under existing SBA affiliation standards, this would not occur.

Without explanation, SBA appears to be ignoring its long history in developing and refining its affiliation measures with this proposed change, a change which may have the unintended consequence of allowing large entities to control small concerns. For example, one firm or even two firms who only have 49% interest each in an applicant's firm would be eligible to participate in the SBIR/STTR Program because neither controlled the board. Shifting away from an "ownership" standard opens up the program to large firms and even foreign owned firms.

Finally, this change in the affiliation rules is only being applied to the SBIR/STTR program and not to SBA overall. SBA is very clear on this point. "…SBA has amended those principles [size and affiliation] solely for purposes of the SBIR and STTR program. "…SBA goes on to say that "…where an SBIR or STTR applicant's voting stock is widely held or two or more persons hold large block of voting stock but no one person owns more than 50 of the stock, then the board of directors controls the applicant."

Although SBA is soliciting comments on alternatives to this proposal, SBTC recommends that SBA should continue to apply its current affiliation provisions to the SBIR/STTR programs. SBIR/STTR firms are familiar with them and no rationale has been offered to support the change. The current affiliation regulations have worked for all other SBA programs and for the SBIR/STTR programs for 30 years. SBA should not have changed the affiliation regulations for the SBIR/STTR program. SBA went well beyond any change needed for venture capital portfolio companies. Venture capital related firms already have access up to 25% of the program. SBA did not need to allow them unfettered access to the rest of the SBIR program.

V. *SBA welcomes comments on any impact the proposed change may have on the SBIR and STTR Programs.*

The SBIR/STTR programs are the most successful R&D programs in the world. 25% of the key innovations come from this small 2 1/2-3% of federal extramural expenditures. The SBIR/STTR programs have been copied in over a dozen countries. Historically their purpose is to involve small businesses in the R&D effort of the Federal Government, maximizing the government's investment in innovations by American small businesses, emphasis on "*American"* and on *"small businesses"*.

One cannot ignore foreign interest in the SBIR program discussed in above. The impact of SBIR investment in the U. S. economy could be seriously eroded if foreign ownership is not dramatically controlled if not curtailed altogether.

To repeat, this emphasis on *American* small business is the bedrock of the provisions in the Small Business Reauthorization Act of 2011 that deal with preserving

and maintaining "**…**the integrity of the SBIR program as a program for small business concerns in the United States by prohibiting large businesses or large entities or foreign-owned entities from participation in the program…"

VI. The *SBIR/STTR Reauthorization Act requires that SBA consider whether participants in the program are at least 51% owned and controlled by U. S. citizens, domestic VCOCs, hedge funds or private equity firms.*

As stated in **II** above, SBTC urges that to be SBIR eligible a firm must be 50+% owned by U. S. citizens and resident aliens. This criterion has withstood the test of time. It is simple. It is clear. It is not susceptible to mis-interpretation.

ADDITIONAL COMMENTS

VII. SBA proposes to change its size regulations to expand eligibility requirements and then uses the change to justify expanding the VC and new eligibility requirements to the STTR program. Congress considered including the STTR program in the VC related provisions and choose not to. SBA wrongly expanded the eligibility requirements to the STTR program.

VIII. SBA should leave size eligibility to be determined at time of contract award. To require eligibility to be determined at the time of proposal submission is a barrier to entry for new entities wishing to submit proposals. SBA should be encouraging scientists to submit proposals and not impose administrative burdens before the time of an award. This requirement is unnecessary

IX. SBA does not even consider that some agencies may chose not to allow Venture Capital related provisions to apply to their agency. The law is clear that an agency may choose not to allow VC related firms to compete in their SBIR program. Nowhere in the regulations does SBA address this issue. Perhaps this will be covered in the upcoming policy directive.

X. The regulatory analysis including its cost benefit analysis and the Regulatory Flexibility Analysis are totally inadequate. For example, SBA did not look at the loss of jobs to overseas firms. It did not consider the impact on currently eligible SBIR firms. The only benefit listed is by allowing foreign and firms affiliated with large business is that the "quality" of proposals will be increased and innovations spurred. SBA did not explain how opening the SBIR program to firms that already have access to 97% of the federal R&D funds will result in more innovations than the 25% on key innovations currently coming from SBIR firms. The RFA analysis is less than 600 words and does not consider the impact on small business. SBA changed the definition of small business to include previously ineligible firms improperly and did not properly consider the impact on current eligible firms.

CONCLUSION

SBA did not comply with the law. It is the stated intent of Congress that the Administrator should promulgate regulations to carryout, "**preserve and maintain the integrity of the SBIR program as a program for small business concerns in the United States** by **prohibiting large businesses or large entities or foreign-owned businesses or foreign-owned entities…"** SBA did not do what the law requires. Instead SBA ignored the law.

SBA's proposal goes well beyond Congress' intent. Loopholes exist in the proposal that can be used to open up the SBIR/STTR program to business concerns not contemplated by Congress – namely foreign owned companies and even large companies. These rules go beyond the 15-25% that the law permits to go to venture capital related firms. These rules apply to the other 75-85% of the SBIR program. These changes dramatically expand eligibility by allowing foreign and even large businesses into the SBIR Program for the first time and there are no safeguards built into the proposal against such a development.

The SBIR/STTR programs have for more than 25 years been designed to encourage small businesses participation in Federal R&D programs, build the domestic economy, foster growth and innovation within the U.S and advance U.S. public interests. SBA's current proposals will significantly alter the purpose of the SBIR/STTR programs and thwart Congress' intent to ensure the involvement of innovative U. S. small businesses in Federal research.

Respectfully submitted,

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