April 29, 2020

The Honorable Steven Mnuchin
Secretary
Department of the Treasury
1500 Pennsylvania Ave NW
Washington, DC 20220

The Honorable Russell Vought
Director (Acting)
Office of Management and Budget
1650 Pennsylvania Ave NW
Washington, DC 20503

The Honorable Jovita Carranza
Administrator
Small Business Administration
409 3rd Street, SW
Washington, DC 20416

Dear Secretary Mnuchin, Director Vought, and Administrator Carranza:

Thank you for your service to our nation, especially during this extremely challenging time. Thank you also for the time and energy you are giving to ensure implementation of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, and the Paycheck Protection Program and Health Care Enhancement Act, are helping to preserve millions of American small businesses, which comprise more than 95-percent of the nation's employing businesses.

We are writing to you as a group of organizations, representing hundreds of companies, with concerns about a segment of small businesses that are falling on particularly hard times during the coronavirus pandemic: American innovative "startups." These young companies were founded by one or more entrepreneurs to develop a unique product or service and bring it to market. Research has repeatedly shown that new businesses account for a disproportionate share of innovation, economic growth, and job creation – and, therefore, are absolutely critical to the nation's ability to weather and recover from the economic blow inflicted by the coronavirus emergency. In 2019 alone, 2.3 million jobs were created across the nation by startups, 98-percent of which have fewer than 100 employees.

In the early stages, startup companies have little or no revenue coming in. Their founders simply have an idea that they wish to develop, test, and market, all within a shoestring operation. Initial get-off-the-ground funding usually comes from the founders or their friends and families. These small dollars are most often followed by funding from venture capitalists and angel investors, which actively seek out promising startups to bankroll in return for a stake in the company once it gets off the ground. But during this global pandemic, many startups are running out of investment money just as revenues dry up, even as they actively work to cut costs. Not only are investors pulling back funds, and even canceling the term sheets that represent funding commitments, but whole segments targeted by startups are in serious trouble, meaning the potential market for innovations beyond the short term is at risk.

This is the very type of coronavirus-related, small business dire situation in which Congress – in crafting the CARES Act – envisioned it to assist. We understand you have received multiple letters from dozens of Members of Congress asking your agencies to intervene in assisting these young companies. Yet, in the way the Act continues to be implemented, our nation's startups have been left without support, at a time when they most need it to keep innovating.

The problem stems from the SBA's definition of "small business" and the predominant startup financing mechanism: equity investment provided by venture capital firms, which typically make investments in a portfolio of young businesses, understanding that many will fail while a few will survive and thrive. To be eligible for the relief and support provided by the CARES Act – particularly access to the SBA's 7(a) loan program – business must meet the definition of small business, which the SBA defines as having fewer than 500 employees. As part of that definition, the SBA applies an "affiliation rule," requiring companies include in their employee count all the employees of companies affiliated with the applicant company. Many relationships can trigger affiliation, including blocking rights in investor agreements or owning a large enough position in the startup. Because venture capital firms typically invest in a number of young companies simultaneously, the affiliation rule would require venture-backed startups to aggregate the employees of all the unrelated companies in which their investors have equity positions, pushing many beyond the 500-employee threshold.

Startup companies that have raised money from investors by issuing convertible securities or that have issued convertible securities to venture debt lenders in connection with debt financing (e.g. options, convertible notes, agreements to merge, and warrants) are also struggling to qualify as small businesses for the purposes of SBA loans in the CARES Act due to affiliation rules, which act "as if" the rights have already been exercised but treat any blocking rights that would normally terminate upon exercise of those rights as still operative. We believe this consequence must be unintended, as most small businesses need to borrow money from banks in order to finance their operations but while those banks require broad blocking rights to protect their loans, the SBA traditionally does not consider them to be affiliates. In fact, venture debt lenders and convertible note purchasers are not truly acquiring control over a company, and when they finally do exercise their convertible rights, may still own only a very small amount of stock in the company.

While we appreciate the SBA's April 23 update to the Paycheck Protection Program Frequently Asked Questions, our membership still believes the guidelines regarding affiliations to be unclear. We also noted the April 24 Interim Final Rule on Requirements for Promissory Notes Authorizations Affiliation and Eligibility, which restates the current affiliation rules and their applicability to private equity-owned businesses as any other business subject to outside ownership or control. Because the combined guidance here is still not clear, we believe it is uncertain which lenders, if any, will feel comfortable processing an SBA loan application from a venture capital-backed startup based on this obscure guidance.

Without clear guidance enabling startups and other small businesses supported by equity investment to access the 7(a) loan facility, many startups will continue to be rendered ineligible. The confusion alone is already leading to entirely preventable layoffs within our startup community. In addition to laying off workers, many young companies will have to shut down critical research and development (R&D) projects in fields like aerospace, bio-research, and artificial intelligence, damaging our country's competitiveness. Many of these companies support elements of our nation's critical infrastructure and need to be protected. Layoffs by startups would also have significant downstream economic consequences for service-oriented businesses like restaurants, coffee shops, and bars, who rely on these workers as customers.

With these very real concerns in mind, we urge the SBA to issue the necessary waiver to the "affiliation rule" that is needed to protect thousands of startups across the nation and the employees who depend on their survival. Specifically, we ask for a "bright-line" test by which any private equity investor who holds a position of 40-percent or less in a company not be relevant to the affiliation rule. In addition, we ask that you issue a clarifying statement or regulatory adjustment to enable private equity backed startups with convertible note holders and/or warrant holders to not be blocked from qualifying as a small business due to the affiliation clause, so long as the blocking rights that otherwise trigger affiliation are customarily held by a debt holder and such blocking rights terminate upon the conversion of the debt to equity or upon repayment of the debt.

Again, we thank you for your service, and ask you to swiftly address these important issues.

Sincerely,

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