



The difference between a VC and a small business: *why SBIR is not the venue for supporting Venture Capitalists*

In a letter dated March 11, 2009, on the FY 2010 proposed budget, House Small Business Committee Chairwoman Representative Nydia Velazquez argues that:

SBA should permit venture capital-backed small businesses to be able to fully participate in the Small Business Innovation Research program.

I laud Representative Velazquez her energy and commitment to supporting innovation and its benefits for the nation's economy, but I question the specifics of her case. By the rules of the SBA regarding the definition of a small business, **nothing prevents venture capital-backed companies from fully participating in SBIR**. The rules however require that small businesses be **majority-owned by individuals**, meaning simply that **venture-capital groups can not own a majority stake** in a small business eligible to compete for SBIR funding.

The question then is what need or benefit is served by **altering the rules** to force individual-owned small businesses to compete against those majority-owned by venture capital groups? Venture capital firms typically have far greater resources than small businesses, providing an unfair advantage because those resources can be expended in the proposal stage. Many truly small firms may find the time and money needed to compete in such a field prohibitive, regardless of the worthiness of their proposed efforts. The **unfortunate consequence** of permitting firms majority-owned by VCs to compete against startups may be to **stifle the innovation SBIR seeks to promote**.

Representative Velazquez continues:

Such participation is essential for high-growth small firms seeking capital, particularly during this period of economic weakness.

The argument appears to be that the capital needed by high-growth small firms can only be provided by **venture capital groups taking a majority-stake in their businesses**. But the outlay of funds from the federal government in the form of SBIR grants and contracts is rather a good source of such capital and cost-effective for the government. Receiving SBIR funding replaces the erstwhile need of many entrepreneurs to sell a majority-stake of their companies to raise working capital.

To be explicit, **SBIR provides an alternative source of support for innovative small businesses** allowing researcher/entrepreneurs to maintain ownership of their firms. Without this source of income, many of these companies will go out of business or be sold off, perhaps losing the critical guidance of the founder. For this reason and many more, SBIR must not be allowed to expire on July 31, 2009.

To be sure, **venture capital serves a useful function in society**. Venture groups can provide an influx of capital for high-growth ventures. **Their motivation however is financial gain not necessarily innovation**. They seek a high return for their investments. There is nothing wrong with the profit motive, it simply should **not be subsidized by public coffers**. Allowing VC majority-owned firms to tap into SBIR resources is akin to providing TARP funds to remodel executive offices. It's the wrong course.

Entrepreneurship and small business innovation are critical for our economy and inestimably beneficial to society. Researcher entrepreneurs are most often **motivated by a passion**, driven by their ideas **to solve problems in innovative ways**. Their incentive is **both innovation for its own sake and the financial gains** that accrue from filling an unserved need. This juxtaposition of overlapping motives keeps innovation at the forefront. SBIR allows federal agencies to define their own high-priority needs.

It has been suggested that some agency administrators are concerned over **difficulty identifying enough high-quality proposals** to support even current levels of SBIR allocations. It is odd that Representative Velazquez would argue that many SBIR-awarded small firms need a greater influx of capital while agency administrators are concerned over not being able to spend all of their SBIR funding. The NIH even went so far recently—apparently motivated by these concerns—to request behind-the-scenes action by a joint House-Senate conference committee ostensibly seeking to reconcile the different versions of the ARRA bill. The result was the insertion of a new clause in the final version **designed specifically to exclude NIH ARRA funding from SBIR/STTR requirements**.

I would think the solution to both concerns can be managed without expanding SBA rules that define small businesses to include majority ownership by venture capital groups, or excluding small businesses from the efforts to stimulate economic activity:

- ✓ Maintain SBA rules that require **majority-ownership by individuals**.
- ✓ Permit agencies **some discretion to provide additional capital** where needed. Capital-intensive programs like some at NIH could be enhanced by permitting the sponsoring agency to spend **some of their SBIR funding** for providing necessary facilities or materials to SBIR-awardees, **without overinflating the individual awards**. Alternatively, the agencies could be allowed some discretion in providing additional amounts (in excess of the base award) for materials and facilities that may be necessary for successful execution of the project. **Oversight would be key** in this case, to ensure that SBIR expenditures are maintained to support SBIR efforts, for instance that residual materials or equipment be retained for future use by SBIR projects.
- ✓ Further, if there is concern that the **costs associated with administering a large number of small awards** is unfunded, a reasonable percentage of the SBIR Base Allocation can be specifically earmarked for this purpose, allaying agencies' resistance to potential increases to the percentages for SBIR Base Allocations.

Finally, I wish to argue that **America is not at a lack for innovative ideas**. If agency's are failing to receive a sufficient quantity of worthy proposals, the solution must lie in publicizing the availability of these programs where they will most garner an appropriate response. This nation has **a shamefully high number of unemployed and underemployed PhDs** from across the spectrum of fields, who could provide the innovation we so desperately need to rise above our current crises.

We have done an abysmal job of employing these valuable individuals in our institutions of higher learning. The popular media focus on tuition increases masks the reality on the ground. There are too few positions available for would-be professors, leaving thousands without an outlet for their creativity. Why not tap this resource? We can do it only with the support of our leaders in Washington. **Improving and expanding SBIR, without losing its focus on small business and innovation, is the first step**.

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