

PILIERO, MAZZA & PARGAMENT, PLLC

ATTORNEYS AT LAW
FARRAGUT SQUARE
888 17TH STREET, N.W.
WASHINGTON, D.C. 20006

DANIEL J. PILIERO II
(1942-1990)
PAMELA J. MAZZA
JEFFREY J. PARGAMENT
ANDREW P. HALLOWELL
ANTONIO R. FRANCO
PHILIP M. DEARBORN III
FRANK C. GULIN
JENNAFER M. SMOKER
JACQUELYN SUSAN STEWART
MANIJEH NAN KARGAHI
JENNIFER M. MORRISON
JEREMY D. ALPER

(202) 857-1000
FAX (202) 857-0200

pmp@pmplawfirm.com
www.pmplawfirm.com

June 17, 2004

VIA FACSIMILE

Mr. Gary M. Jackson
Assistant Administrator for Size Standards
U.S. Small Business Administration
409 Third Street, S.W.
Mail Code 6530
Washington, D.C. 20416

Re: Comments to Proposed Restructuring of Size Standards

Dear Mr. Jackson:

I. Introduction

Our firm provides legal services to a variety of small, small and disadvantaged and 8(a) certified firms nationwide. We are writing to submit our comments to the proposed regulations issued by the Small Business Administration (“SBA”) on March 19, 2004. In general, we do not believe that the proposed changes to the current size standards are necessary. If changes must be made, we believe that the SBA should postpone finalizing regulations converting revenue-based size standards to employee-based size standards until data from the 2002 Census is available for an accurate conversion. Further, the initial conversion should not attempt to restrict the number of employee size standards so dramatically from thirty-seven (37) to ten (10). Equity requires that, to the extent possible, the new employee size standards should correspond with the current revenue-based codes. If enacted in their current form, the proposed regulations would likely have a serious adverse effect on many small businesses.

We discuss below our comments to the regulations.

II. Comments

The SBA’s proposed regulations could potentially result in 34,100 businesses losing their

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 2

small business eligibility. We are not convinced that the benefits of SBA's goal of simplicity would outweigh the burdens to these businesses. Further, we are not convinced that the proposed regulations would simplify anything but the number of size standards available. Simplification for its own sake is not worth abruptly disqualifying formerly small businesses. We recommend that the SBA take more time to consider the issues raised herein.

A. Transitional and Reliance Problems

We urge the SBA to reconsider the potential impact this proposal would have on the small business community and the overall U.S. economy. Undoubtedly, implementation of the proposed regulations would create a turbulent transitional period. Such a disturbance is unnecessary.

No harm should come to any current small business under the proposed regulations. As drafted, however, it appears that significant and unnecessary harm would come to many, while it is unclear how many newly small companies would even step in to compete for small business set-asides.

Numerous small businesses have formulated business plans and invested heavily in preparing bid proposals based on their current status as small businesses. A dramatic change in the playing field would be unfair and unduly disruptive to many thriving small businesses that have carefully followed SBA regulations, only to face overnight ineligibility or decertification.

B. Potential Negative Impact on Mid-Size and Large Businesses

If implemented, the proposed standards would have the effect of abruptly moving currently small businesses out of the small business arena and into competition with larger, more developed businesses. These now "mid-sized" businesses may lack the well-developed infrastructure and complex service capabilities required to compete effectively against seasoned government contractors to perform contracts that are growing larger and more complex. Agencies are increasingly bundling several task orders into one large contract, which often requires advanced capabilities and a larger employee (and revenue) base than the proposed regulations permit for small businesses. The unintended effect of the new size standards would be to curtail the diversity and innovation often associated with small businesses, such as small information technology ("IT") firms, since small businesses under the unreasonably low employee size standard for the IT industry simply could not compete for large federal contracts that demand significant resources for performance.

Additionally, the proposed standards would negatively impact large businesses and government agencies seeking to meet their small-business subcontracting and procurement goals, respectively, because of the lack of small businesses that would be available in IT and other sectors of the economy under the proposed rules. A small business community deprived of the opportunity to perform as primes or subcontractors on complex government contracts is thus not in the best

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 3

interest of the government or the private sector.

C. Administratively Burdensome Receipts Caps

Despite the fact that SBA proposes a shift to employee size standards, it proposes to retain receipts-based size standards for industries in which subcontracting occurs more heavily than usual, such as in the construction industry. These receipts-based size standards are designated as “caps,” although in application, they appear to function in the same manner as the size standard. Those industries that would be subject to essentially two size standards would face the administrative burden of maintaining two sets of information—payroll and financial data—specifically for the purpose of determining their size. Granted, most of this data is (or should be) maintained by all firms; however, these firms would be charged with organizing and analyzing two sets of data for size purposes when other firms would need only to concern themselves with one.

In addition, by requiring certain firms to comply with two size standards, the SBA would be unfairly holding such firms to a higher standard than others. If the employee-based standard is not expected to work well with such firms, why use it at all for these industries? Standardization for the sake of simplification makes little sense if exceptions are required where previously none existed.

We believe that the proposal to add a maximum average annual receipts cap as an additional component of the size standard for certain industries is a mistake. The SBA’s rationale behind this proposed action is not clear, and we urge the SBA to reconsider this aspect of the proposed regulations.

First, by carving out this additional cap for some industries, the SBA’s proposal is at odds with its stated intention of simplifying the size standards. This proposal runs counter to the proposition of transitioning from a receipts-based system to an employee-based one.

Second, the SBA justifies the receipts cap, in part, by stating that it aims to prevent businesses operating in “. . . industries that have greater latitude in subcontracting significant portions of work . . .” from purposefully subcontracting a relatively large amount of work in order to retain their small business status. 69 Fed. Reg. 13135 (2004). However, this proposal is duplicative of a regulatory scheme that already exists to prevent such abuses. For example, under 13 C.F.R. §125.6(a)(3), a prime contractor with construction contracts must perform at least fifteen (15) percent of the cost of the contract with its own employees, not including the costs of materials. Thus, the stated concern that the receipts cap is designed to address is already covered by 13 C.F.R. §125.6. If the SBA believes that 13 C.F.R. §125.6 should be amended, then it should issue a proposed regulation through a separate rulemaking to revise the provision, rather than attempting to address any alleged deficiencies in protecting against gaming of the system through the instant proposed rules.

In sum, the proposal to add a maximum average annual receipts cap as an additional

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 4

component of the size standard for the construction industry, among others, is contrary to the SBA's goal of simplification and is duplicative of an already existing regulatory framework. If the SBA is concerned about abuse of the employee-based system, then one may inquire why it is shifting to an employee-based standard for most industries. Even if the SBA implements the proposed regulations, we urge the SBA to re-examine and eliminate receipts caps on employee-based standards.

D. A One-Year Payroll Average is More Onerous Than a Three-Year Financial Average

The differences between the current and proposed size standards are not limited to characterizations of the respective rules as "employee-based" or "receipts-based." In converting from receipts-based standards to employee-based ones, SBA proposes to require firms currently using a three-year financial average to switch to a one-year payroll average. The three-year financial average is based on the company's fiscal year, whereas the one-year payroll average is calculated on a rolling basis counting backwards from the last full calendar month. The ramifications of these differences are significant.

Obviously, an average that is calculated over a longer period of time will change more slowly than an average calculated over a shorter period of time. For example, assume that a retail store has total sales of \$20 on day 1, \$30 on day 2, \$40 on day 3, \$50 on day 4, \$60 on day 5, and \$70 on day 6. The average sales for such store over 6 days would be \$45. However, the average sales for such store over the most recent 3 days would be \$60. If the size standard were \$50, the difference in the length of time for the calculation would determine whether the firm would fall within or exceed the size standard.

Further, the fact that each of the calculations focuses on different segments of time creates further differences in these size standards. The financial average is based on a fiscal year that changes on an annual basis and the payroll average is based on a twelve-month period that changes on a monthly basis. This means that a firm whose standard is calculated based on the fiscal year could have up to twelve months in between the time that it converts from small to other-than-small. Conversely, if such firm exceeds the size standard, it could be ineligible as a small business for up to twelve months if its size were to immediately decrease. In contrast, a firm whose size is measured on a twelve-month rolling average may be small in month 1, other-than-small in month 2, and small again in month 3, depending on whether its payroll increases or decreases. It is conceivable that a firm that certifies as small on December 29, 2004, would rely on financial data dating back nearly four (4) years under a receipts-based standard but such a firm under an employee-based standard would, at most, look back just under thirteen (13) months.

In light of this difference, one can hardly argue that the proposed regulations were not intended to bring about a substantive difference in a firm's size. Before implementing such radical changes, SBA should consider whether the employee-based standard fairly and accurately represents the status of a firm as small and whether the conversion it seeks actually accomplishes its goal of administrative simplification.

Mr. Gary Jackson
June 17, 2004
Page 5

As we have said, we believe that the SBA should not implement the proposed rules for a number of reasons. However, if the SBA decides to go forward with the proposed regulations, then it should take steps to mitigate the harmful effect this proposal would likely have on many small businesses. Along these lines, one suggestion we have heard to ameliorate the potential harmful impact of the proposed regulations is to calculate the number of employees over multiple years instead of implementing the current proposal to calculate the number of employees every year. In that way, consistent with the current three-year revenue-based calculation, a small business would be able to win a substantial contract and still compete as a small business while continuing to grow and develop, consistent with the SBA's goals. In this manner, firms would have the ability to develop more accurate business plans that allow them to forecast the length of their eligibility for SBA programs. Accordingly, if the SBA implements the proposed regulations, we urge the SBA to consider revising the employee-based size standards to reflect an aggregate number of employees over several years.

E. Problematic Use of 1997 Census Data to Convert 2002 NAICS Codes

In order to calculate many of the proposed employee-based standards, we understand that the SBA analyzed and compared 1997 Census data from 446 industries, categorized according to the 1997 NAICS (See Exhibit 1). However, many of the 1997 NAICS codes and their definitions changed by the time of the 2002 Census. Of the 446 industries with 1997 data that SBA considered, 23 of the codes were split into new categories and nine (9) more were consolidated into new categories that also contain enterprises from at least one split category. Further, one (1) category was redefined to encompass a different set of enterprises. The use of 1997 Census data for split codes incorrectly assumes that the revenue-per-employee ratio is uniform throughout a split category. In addition, SBA received Census data on six (6) categories with current asset-based standards and acknowledged that such data could not be used in converting to an employee based size standard. A different method was used to calculate the size standard for these categories. Thus, it is our view that only 407 of the proposed size standards can be analyzed by using Census data provided to the SBA.¹

It is unclear how the SBA can justify the 33 proposed size standards for which Census data was inadequate because the NAICS categories had been split, consolidated or redefined. For this reason, it is only logical to postpone finalizing conversion of size standards until publication of the most recent Census data allows for the most accurate conversion possible.

¹ Moreover, there is no Census data at all related to approximately 50 of the 514 proposed size standards.

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 6

F. “Winners and Losers” Through the Conversion.

In order to properly analyze the SBA’s conversion of size standards, we attempted to replicate the SBA’s mathematics in converting current receipts-based standards into employee size standards (See Exhibit 2). We adjusted the 1997 Census data on receipts-per-employee for inflation, and divided the revenue size standards by that ratio to arrive at anticipated employee size standards. We expected that the anticipated employee numbers would be fairly close to the size standard proposed by the SBA. We were troubled, however, with the number of NAICS codes in which the anticipated standard deviated significantly from the proposed standard. Of the 407 proposed standards for which the SBA had comparable Census data, we determined the following:

- 1) 124 proposed size standards are more than 20% too large.
- 2) 144 proposed size standards are more than 20% too small.
- 3) Only 139 proposed size standards are within 20% of the anticipated value.

The discrepancy in the employee size standards would generally benefit industries that are more technologically complex, require highly specialized experience or have higher receipts per employee. A variety of other industries would be burdened by the conversion. For example, the following industry subsectors would generally experience a decrease in their relative size standards under the proposed regulations:

- Subsector 5322 – Consumer Goods Rental (except 532291)
- Subsector 5323 – General Rental Centers
- Subsector 611 – Educational Services (except 611430 and 611710)
- Subsector 6212 – Offices of Dentists
- Subsector 6213 – Other Health Practitioners
- Subsector 624 – Social Assistance
- Subsector 7111 – Performance Arts Companies
- Subsector 7121 – Museums, Historical Sites, and Similar Institutions
- Subsector 713 – Amusement, Gambling and Recreation Industries (except 713110 and 713930)
- Subsector 721 – Accommodation (except 721120)
- Subsector 722 – Food Services and Drinking Places (except 722310)
- Subsector 8111 – Automotive Repair and Maintenance
- Subsector 8114 – Personal and Household Goods Repair and Maintenance
- Subsector 8121 – Personal Care Services
- Subsector 8122 – Death Care Services

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 7

Industry subsectors that would generally experience an increase in relative size standards are as follows:

Subsector 522 – Credit Information and Related Activities (except 522310)

Subsector 523 – Financial Investments and Related Activities

Subsector 5241 – Insurance Carriers and Related Activities

Subsector 525 – Funds, Trusts and Other Financial Vehicles

Subsector 5311 – Lessors of Real Estate

Subsector 5321 – Automotive Equipment Rental and Leasing

Subsector 5324 – Commercial and Industrial Machinery and Equipment Rental and Leasing

Subsector 562 – Waste Management and Remediation Services (except 562991)

Subsector 8132 – Grantmaking and Giving Services

The NAICS code with the largest increase – Secondary Market Financing (522294) – has a proposed size standard (50 employees) that is 3134% larger than the size standard anticipated based on its average employees (1.5). This hardly seems reasonable and brings into question whether 50 employees is the right place to begin.

These discrepancies in benefits and burdens are not justified by any administrative need to simplify the number of size standards. The SBA has not offered a compelling argument as to why changes must be made that would have such a widespread and inequitable impact.

G. Negative Impact on Firms Reliant on Temporary and Part-Time Employees

One of the features of the proposed regulations, as with the current regulations, is that employee-based standards that do not differentiate between full-time and part-time employees have a heavier impact on firms that are more reliant on part-time employees.² Converting from a mixed receipts- and employee-based system to one based nearly exclusively on employees would likely bring the most harm to such firms. Further, requiring employers to maintain information on temporary employees who may only work for a firm for a short period of time and may not even be on the firm's payroll can create a significant administrative burden on such firms. Although this is the same for firms in industries that currently have employee size standards, it is not a good model upon which to base converted size standards.

Under the current and proposed regulations, there is no difference in treatment for full-time employees and part-time employees. The calculation for the average number of employees is based on the average payroll numbers over the preceding twelve (12) months. Regardless of how many

² To exacerbate the problem, examples from Exhibit 2 illustrate the degree to which size standards for industries that typically rely on temporary and part-time labor would shrink under the proposed regulations. Some of the firms whose proposed standards would shrink the most include the following: Tax Preparation Services (541213), Full Service Restaurants (722110), Limited-Service Restaurants (722211), Cafeterias (722212), Drinking Places (Alcoholic Beverages) (722410), Snack and Nonalcoholic Beverage Bars (722213), Exam Preparation and Tutoring (611691), Child Day Care Services (624410), Beauty Salons (812112) and Nail Salons (812113).

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson

June 17, 2004

Page 8

hours an employee has worked, if that employee receives a paycheck in any particular pay period, that employee will count towards the average. For example, a firm that has 100 employees who work 20 hours per week would be large under a 50-employee size standard. However, a firm that has 50 employees who work 40 hours per week would still fall within that same standard. These two firms could have identical man-hours, but the fact that one firm divided each work day between two employees and the other performed it with one employee would cause the firm with part-time employees to be other than small.

There appears to be no justification for this distinction. On the one hand, counting each employee equally simplifies the process of calculating a firm's size, although it creates potential inequities among similarly situated firms. On the other hand, if the SBA were to consider the total number of a firm's man-hours per year and divide that by the number of full-time hours in a year in order to arrive at an average number of employees, the administrative burden on firms required to keep such records could be even greater than the burden of maintaining accurate payroll figures. In order to finalize the proposed regulations, the SBA must analyze them and any future permutations of the proposed regulations by comparing the benefits of administrative simplification against the creation of inequalities. Administrative simplicity at the expense of equity between and among similarly situated small businesses is not a good trade. A simpler and fairer approach would be to maintain the status quo under the current receipts-based size standards.

In particular, the proposed regulations would have an adverse impact on service industries, such as facilities management, which are characterized by a high rate of employee turnover, as well as by the use of part-time and temporary workers. Requiring employers in service industries to maintain a rolling 12-month matrix of employees, including part-time and temporary employees, is a daunting task to many small businesses in these industries. Indeed, a number of small businesses have expressed concern to us regarding this added administrative burden. Verifying one's average revenue over a three-year period based on federally filed tax returns, as is required under the current rules, does not constitute a large administrative burden for most businesses. Tracking a stream of all employees on the payroll throughout the year, including part-time and temporary employees, in contrast, is a substantial task and added burden for many companies with limited resources, which may not be justified by the Government's purpose in proposing the rule change.

Many businesses in these industries, to the extent they rely on high numbers of temporary and part-time employees, would be disadvantaged by the proposed regulations because they would exceed the proposed size standards faster than comparable businesses that utilize fewer employees. In addition, the SBA's estimates as to the number of small businesses across the U.S. economy that would still be considered small under the proposed regulations do not appear to contemplate the extent to which this number would be reduced by the number of small businesses that may voluntarily exit the small business government contracts arena due, at least in part, to these added burdens.

PILIERO, MAZZA & PARGAMENT, PLLC

Mr. Gary Jackson
June 17, 2004
Page 9

III. Recommendations

We recommend that the SBA postpone issuance of proposed regulations until it can adequately justify the need for simplification. This requires studying 2002 Census data and the impact that changes will have on existing small businesses. In order to further SBA's purpose and lighten the effect on existing small businesses, a transition period should allow for currently small firms to be grandfathered or permitted some additional time until the regulations would apply to them in full.

IV. Conclusion

The proposed regulations are simply premature. It is not reasonable to implement changes that could impact the stability of our national economy or disqualify firms for SBA assistance based on comparisons to information that translates poorly into current figures. SBA should wait for the 2002 Census data in order to be able to make the most equitable and rational conversion possible. Further thought should be given to the other issues raised in these comments, including the issues of subcontracting concerns, temporary employees and the length of time over which the size of a firm should be measured.

In any event, if the SBA moves forward with the proposed regulations, the government should at least delay the implementation of the new regulations or create a grandfathering period for current small businesses. It would be arbitrary and unfair to implement these regulations immediately without a grandfathering period. Companies that have developed business plans under SBA guidance and assumed that the SBA had a stable federal policy on small business are counting on continued eligibility and steady growth under the current rules.

If you have any questions, please do not hesitate to contact us.

Sincerely,

Pamela J. Mazza
Jennafer M. Smoker