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MEMORANDUM

To: Clients and Friends

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Date: October 28, 2009

Re: SBA Issues Proposed Changes to Its Small Business Size and 8(a) Business Development Regulations

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On October 28, 2009, the Small Business Administration ("SBA") issued numerous and in some instances dramatic proposed changes to its small business size and 8(a) Business Development Program ("8(a) Program") regulations. See Small Business Size Regulations; 8(a) Business Development/Small Disadvantaged Business Status Determinations, 74 Fed. Reg. 55694 (October 28, 2009). The SBA is proposing amendments to a broad spectrum of its rules including those pertaining to joint ventures, the mentor/protégé program, size determinations, 8(a) eligibility, 8(a) economic disadvantage thresholds, rules for tribes and Alaska Native Corporations, and the nonmanufacturer rule.

This client alert is designed to help you understand the proposed rules and the ramifications should they become final. The enclosed chart details many of the proposed rules, the current version of the rule, and our initial thoughts on what the changes would mean for you. While we have not covered all of the proposed rule changes, our chart will give you a good sense for the direction SBA is planning to take several of its key programs.

In the days and weeks ahead we will make fuller comments available through additional client alerts and on our website. In the meantime, once you have reviewed the enclosed information, we would like to hear from you about the proposed rules, how your business may be impacted, and what you would like to see changed before the rules become final. Please share your thoughts with us by contacting Jonathan Williams, Kelly DiGrado, or any other member of our team at 202-857-1000.

Finally, please note that public comments on the proposed rules will be accepted until December 28, 2009. We strongly encourage affected firms to submit their comments to the SBA. If you would like our assistance in preparing such comments, or have any questions about the proposed rules and the comment process, please do not hesitate to contact us.

Joint Ventures

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 121.103(h)	The so-called "3 in 2" rule, which states that two firms are limited to pursuing three contract opportunities under one JV. To pursue an opportunity means to submit an offer.	The "3 in 2" limitation would change from three *offers* to three *contract awards* under one JV.	We are in favor of this proposal since it would lessen the need for additional JVs.
13 C.F.R. § 121.103(h)(3)(iii)	As OHA confirmed in Size Appeal of SES-TECH Global Solutions, SBA No. SIZ-4951 (2008), the 8(a) JV rules currently apply only to MP JVs that pursue 8(a) contracts.	SBA proposes to amend § 121.103(h)(3)(iii) to make clear that any JV seeking to use 8(a) MP status as a basis for an exception to affiliation must follow the 8(a) JV rules set forth in § 124.513(c), (d).	SBA will not require prior approval of MP JVs that pursue non-8(a) contracts, but if the JV faces a size challenge it must be able to show compliance with the 8(a) JV rules to qualify for the MP JV affiliation exception.
13 C.F.R. § 121.103(h)(3)(iii)	Two firms in an approved MP arrangement may JV as a small business for *any* federal procurement, provided certain criteria are met.	SBA is seeking comment on whether to permit the MP JV exclusion from affiliation for only 8(a) contracts. This would mean that a large business mentor could not JV with a protégé for small business set-asides.	Limiting MP JVs to 8(a) contracts is contrary to the intent of the 8(a) Program, which is designed to foster the participant's ability to function outside of the program on non-8(a) contracts. Restricting contract opportunities for MP JVs would also limit the utility of the MP program for mentors, which in turn would likely limit the pool of mentors. Further, SBA should consider changing the definition of "federal procurement" to include contracts such as those issued by the DOE Facilities Operators.
13 C.F.R. § 124.506(b)	Provides exemptions from competitive sole source thresholds for 8(a) firms owned by Indian tribes, ANCs and NHOs.	Because SBA believes this rule has permitted large businesses to unfairly benefit by forming a JV and then also serve as a subcontractor to the JV, SBA is modifying the rule to provide that non-8(a) JV partners *cannot* be subcontractors to the JV on 8(a) sole source contracts.	This proposed rule is meant to address perceived abuse, but we believe it would go too far and would undermine the utility of the MP program. SBA should consider alternatives such as requiring that a specific percentage of work on sole source 8(a) contracts be performed by the 8(a) firm.

13 C.F.R. § 124.513(c)(3)	The 8(a) JV partner must receive 51% of the profits from the JV.	Recognizing the inequity this requirement causes when the non-8(a) firm performs more of the work in the JV, SBA proposes to amend this rule to provide that the 8(a) JV partner must receive profits from the JV commensurate with the work the 8(a) partner actually performs.	We agree that a profit split equal to work performed is a more equitable arrangement for 8(a) firms and non-8(a) mentors, which would strengthen the MP program.
13 C.F.R. § 124.513(d)	For 8(a) JVs, the performance of work rule is satisfied through the JV. This means the JV partners may also serve as subcontractors for a significant portion of the JV prime contract.	SBA has requested comment on whether it should prohibit non-8(a) JV partners from being subcontractors under *any* 8(a) prime contract awarded to a JV.	This could be damaging to the MP program. Mentors commonly subcontract a portion of the work under a MP JV, both because the 8(a) is not able to perform the entire project (hence the need for the MP arrangement), and as an inducement to prospective mentors. We do not believe non-8(a) JV partners should be prohibited from subcontracting because oftentimes, an unpopulated JV is more beneficial to both firms.
13 C.F.R. § 124.513(d)	The 8(a) JV partner must perform a "significant portion" of the work done by the JV. There is no definition of "significant portion" in the current regulation.	SBA is proposing to define "significant portion" to mean that the 8(a) JV partner must perform at least 40% of the work done by the JV. This would mean that if the JV performs 50% of a contract, the 8(a) must perform 40% of 50%, or 20% of the entire project.	We believe that an objective measure should be avoided in this rule because a "significant portion" of the work for an 8(a) concern will vary based on the type and size of the project. By requiring a uniform percentage across the board, this may unintentionally limit 8(a) firms' ability to contract and take full advantage of the MP program.

Mentor/Protégé

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 121.103(b)(6)	This rule provides an exemption from affiliation when one firm provides assistance to another under a federal MP program.	SBA did not intend the MP exemption to be triggered by MP programs from other federal agencies. Therefore, SBA will modify rules to make clear that the MP affiliation exception will only apply to firms in a MP program specifically authorized by statute (i.e., the SBA or DOD MP programs) or where SBA has authorized an exception for another federal agency's MP program.	SBA does not anticipate approving many exceptions, so the proposed rule will greatly reduce the utility of the other federal MP programs. We are not in favor of this because currently, there is no MP program available through SBA for HUBZone and SDVO firms and other small businesses.
13 C.F.R. § 124.520(b)	Nonprofits cannot serve as mentors because they are not considered to be a "concern" as that term is used in this regulations and defined in 13 C.F.R. § 121.105.	SBA is considering changing the regulation to permit nonprofits to serve as mentors.	We are in favor of this measure because it will increase the pool of potential mentors, which in turn would benefit 8(a) firms.
13 C.F.R. § 124.520(b)(2)	Generally, mentors may have only one protégé at a time unless SBA approves more.	Under the proposed rule, SBA would impose an absolute limit of three protégés per mentor at a time	This is a reasonable limitation, as the purpose of the program is better served if 8(a) firms receive more individualized attention and assistance from their mentor.
13 C.F.R. § 124.520(c)(2)	Only firms in good standing in the 8(a) Program are eligible to be a protégé.	SBA intends to clarify that this means the benefits of the MP program end once the protégé exits the 8(a) Program. A JV between a mentor and protégé would be expected to complete any contract awarded to the JV while the protégé was in the 8(a) Program.	This is helpful guidance because many firms are unsure what becomes of their contracts and MP arrangements once the MP agreement terminates.

13 C.F.R. § 124.520(c)(3)	Protégés may have only one mentor.	Recognizing that in some cases a second MP relationship is warranted, SBA proposes to allow a second mentor in limited circumstances when the second mentor relationship pertains to an unrelated, secondary NAICS code and the first mentor does not have the specific expertise that the second mentor can provide.	We are in favor of making additional resources and business development opportunities available to 8(a) firms in the form of a second mentor.
13 C.F.R. § 124.520(c)(5)	Currently, an 8(a) firm is eligible to be a protégé if it is in the developmental stage of the 8(a) Program, has never received an 8(a) contract, or is half their applicable size standard.	SBA proposes to prohibit an 8(a) firm in the last year of the program from being eligible as a mentor. SBA seeks comments on the appropriate time before the end of a firm's program term when protégé eligibility would end.	We believe this rule is contrary to the intent of the 8(a) program, which is designed to foster the 8(a) firm's ability to succeed once it has exited the program. This goal is not served by limiting when a participant is eligible to receive mentoring, particularly when the firm is on the cusp of leaving the program. We favor no such restriction, or at worst a period of no more than three months prior to the end of the program term. With three months remaining, an 8(a) firm would be unlikely to obtain any new contracts as a result of the MP relationship.

Nonmanufacturer Rule

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 121.402(b)	Procurements for supplies must be classified under the appropriate manufacturing NAICS code, not under the wholesale trade NAICS code.	SBA proposes to modify this rule to clarify that a procurement for supplies also cannot be classified under a retail trade NAICS code.	We are in favor of this clarification because agencies have had difficulty understanding and applying the nonmanufacturer rule.
13 C.F.R. § 121.406(b)	The SBA's so-called "nonmanufacturer rule" permits a nonmanufacturer to provide the product of another small business, or, if the rule is waived, the product of a large business.	SBA will clarify the nonmanufacturer rule to explicitly state that the rule applies only to a manufacturing procurement with a manufacturing NAICS code, but not to a supply contract. SBA will also make clear that when a manufacturing contract involves some services, the nonmanufacturer must supply the product of a small business but need not perform any specific portion of the services, which cannot be considered primary and vital.	These clarifications will be helpful to address confusion surrounding the nonmanufacturer rule and confirm that any services performed on a supply contract are merely incidental to the supplies, since supplies necessarily are the primary and vital requirements of a supply contract.
13 C.F.R. § 121.406(b)(ii)	To be eligible as a nonmanufacturer, a firm must be primarily engaged in the retail or wholesale trade and normally sell the type of item being supplied under the contract.	SBA will add that the nonmanufacturer must take possession of the item with its personnel.	SBA states that this change is in response to situations where the nonmanufacturer rule is waived and a firm essentially subcontracts all services, such as warehousing and delivery, to a large business. It is unclear how this proposed rule is reconciled with the proposed rule clarifying that a nonmanufacturer need not perform any specific portion of the incidental services on a supply contract. We believe the SBA should provide a clarification.

ANCs, Tribes, & NHOs

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 124.109(b)(2)	This regulation requires tribes to demonstrate their economic disadvantage through the submission of data, including information relating to tribal unemployment rate, per capita income of tribal members, and the percentage of the tribal population below the poverty level.	Tribes are requested to comment on how SBA should assess economic disadvantage for tribal 8(a) companies. Some options included a bright line assets or net worth test. SBA also requests comments on whether a tribe should be required to determine its economic disadvantage more than one time.	Tribes should weigh in on these issues, which have the potential to lead to more onerous requirements for tribal 8(a) firms.
13 C.F.R. § 124.109(c)(3)(ii)	A tribally-owned 8(a) applicant cannot have the same primary NAICS code as another tribal entity that has already been admitted into the 8(a) Program, or that has left the Program within the last two years. However, the regulation allows the applicant to perform secondary work in the same NAICS code as another tribal firm.	One tribal entity cannot receive a contract in a secondary NAICS code that is the primary NAICS code of another 8(a) tribal entity. As an alternative, SBA is also considering allowing the applicant to perform no more than 20% or 30% in the secondary code.	This will be unduly restrictive for tribal 8(a) firms. The goal should be to promote the development of both firms, and this is better served by permitting secondary sources of business for 8(a) firms. Further, this proposed rule would discourage tribal entities from accepting work that has been classified under a NAICS code other than their primary code, in the event that a sister tribal entity desires to apply for 8(a) certification under that code. Oftentimes multiple NAICS codes are assigned to a contract, so some level of flexibility should be permitted. We recommend that SBA simply implement the proposed change to 13 C.F.R. § 124.3, which would allow a firm to change its primary NAICS code, thereby eliminating the need for the proposed rule change under section 124.109.

13 C.F.R. § 124.109(c)(4)	Tribal 8(a) firms must generally be managed by individuals that are members of the tribe that owns the concern.	SBA requests comments on whether this rule is too restrictive and whether membership in any tribe should suffice.	A rule allowing tribes to hire non-tribal members to manage 8(a) concerns would be beneficial to tribal concerns and allow more economic development within the tribes.
13 C.F.R. § 124.112(b)	ANCs must certify as to certain eligibility requirements as part of the annual review process.	Annual ANC reviews will require information on the extent to which benefits are reaching individual Alaska natives or the native community. The same reporting requirements may also be applied to 8(a) Participants owned by tribes, NHOs and CDCs.	ANCs provide this information in reports to shareholders, so this new requirement should not be onerous.
13 C.F.R. § 124.204(a)	SBA's Anchorage, Alaska District Office initially reviews all applications from ANC-owned firms.	ANC 8(a) applicants will be reviewed out of San Francisco, not Anchorage, and SBA may send some cases to Philadelphia.	We have no comments but recommend that SBA provide these offices with the staff to process applications.
13 C.F.R. § 124.519	ANC and tribally-owned concerns are exempt from limitations on the amount of contract dollars that a firm may receive on a sole source basis.	SBA proposes to extend the sole source exemption to NHO firms as well.	This reflects the current state of the law.

Size Issues

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 121.1001(b)	SBA's IG is not currently identified in the regulations as an individual who can request a formal size determination.	The IG would have authority to ask for a formal size determination, particularly in the context of an investigation or other review of SBA programs by the IG.	This change reflects the increased IG activity we have seen at the SBA in recent months, and suggests there will be more IG scrutiny of SBA programs going forward.
13 C.F.R. §§ 124.112, 124.3	Currently neither regulation permits an 8(a) Participant to change its primary NAICS code, even if it can demonstrate that its revenues have evolved from one primary NAICS code to another.	The definition of primary NAICS code will be amended to specifically recognize that a Participant may change its primary NAICS code where it can demonstrate that the majority of its revenues during a two year period have evolved from its former primary code to another code. The proposed rule would also add a provision to permit a Participant to request a change in its primary NAICS code with its servicing district office.	This rule would allow a firm that has exceeded the size standard corresponding to its primary NAICS code to change its primary NAICS code and remain in the 8(a) Program, so long as the firm can demonstrate that it qualifies as small under another primary NAICS code.

8(a) Program Eligibility

Rule Citation	Current Rule	Proposed Changes	PilieroMazza's Comments
13 C.F.R. § 124.102, 124.302	13 C.F.R. § 124.102 provides that a firm must qualify as small under its primary NAICS code when it applies for the 8(a) Program. Historically, SBA has permitted firms to remain in the 8(a) Program and receive 8(a) contracts in their secondary NAICS codes as long as they remained small for such secondary codes, even if they no longer qualified as small under their primary NAICS code. In determining whether to graduate an 8(a) firm early, SBA considers a number of factors under section 124.302, including sales trends, degree of sustained profitability and current ability to obtain bonding.	SBA proposes to amend section 124.102(a) to require that a firm *remain* small for its primary NAICS code during its term of participation in the 8(a) Program. Additionally, in determining whether to early graduate an 8(a) firm, this rule proposes to revise section 124.302 to *permit* SBA to consider, among other factors, whether the firm exceeds the size standard corresponding to its primary NAICS code for two successive program years.	We are not in favor of these proposed changes because they indicate SBA will take more actions to remove firms from the 8(a) Program before the firms have received the full benefits of the program.
13 C.F.R. § 124.104	This regulation authorizes SBA to use personal income as a basis for determining economic disadvantage, but does not identify a specific level of income below which an individual would be considered economically disadvantaged. A threshold of $200,000 has been established through OHA cases.	SBA proposes to codify the $200,000 AGI threshold.	We understand the need for a bright line rule, but we disagree that business owners should be measured against all U.S. taxpayers, including college students, etc. The 8(a) Program is designed to develop businesses. Restricting the amount of income an owner can receive stifles access to credit and capital and limits the quality of employees that can be hired since the owner must be the most highly compensated. A true measure of an owner's economic disadvantaged would be based upon consideration of the firm's geographic location and industry.

13 C.F.R. § 124.104	The regulations do not currently provide that any particular AGI renders an 8(a) firm ineligible for continued 8(a) participation. However, recently, SBA district offices have been questioning socially disadvantaged 8(a) owners whose income exceeds $200,000.	SBA proposes to require a two year average income of $250,000 for continued 8(a) Program eligibility.	$250,000 is too low of a benchmark. Setting a bright line rule for continued eligibility is arbitrary for the reasons discussed above regarding the income threshold for initial program eligibility.
13 C.F.R. § 124.104	The SBA's SOP provides that S Corporation income that was reinvested in the firm should not be counted towards SBA's calculations of personal income; however the regulations do not provide the same.	The proposed regulation would codify the SOP guidance. Specifically, the proposed regulation states that S Corporation income will *not* be considered in determining an individual's annual income or net worth if the S Corporation owner submits evidence that such income was reinvested in the firm or used to pay corporate taxes within 12 months of the distribution of income.	There is conflicting OHA guidance regarding this issue so we welcome SBA's codification of this rule.
13 C.F.R. § 124.104(b)(2)	When married, an individual claiming economic disadvantage also must submit separate financial information for his or her spouse.	SBA may consider spouse's financial situation in determining an individual's access to capital and credit.	A spouse's finances should only be reviewed if the spouse is active in the business or lending money to the company; otherwise this proposed rule will lead to the disqualification of firms that are eligible for the program but for the spouse's finances, even if the spouse will have no role in the company.
13 C.F.R. § 124.104(c)(2)	When determining an owner's economic disadvantage, SBA excludes the ownership interest in the applicant or Participant and the equity in the primary personal residence in its calculation of net worth.	SBA proposes that IRAs and other retirement funds will not count toward an applicant's personal net worth, so long as the funds cannot be withdrawn early without a significant penalty.	We are in favor of this exclusion from the personal net worth calculation, since retirement accounts are not commonly accesses or treated as an asset prior to the age of retirement.

13 C.F.R. § 124.104(c)	This regulation provides that SBA may consider "the fair market value of all assets, whether encumbered or not" in determining whether an individual is economically disadvantaged. The rule does not provide a bright line rule regarding what level of total assets would be impermissible.	SBA proposes to find a lack of economic disadvantage when a firm has greater than $3 million in total assets at the time of application for the 8(a) Program, or $4 million in total assets once in the program.	Though this rule has seldom been used as a means to deny or remove firms from the 8(a) Program, we are concerned about a rigid test for assets that does not account for individual circumstances. Similar to our views on the individual income thresholds discussed above, we believe a more individualized approach is necessary to assess whether a particular firm lacks economic disadvantage. The rules on personal income and excessive withdrawals are drafted to encourage owners to retain the earnings of the company. To limit retained earnings conflicts with that concept and may limit the amount of time a Participant can use this nine year program to develop its business to become competitive. Retained earnings are important and should be encouraged.
13 C.F.R. § 124.105(g)	This rule currently provides that "individuals determined to be disadvantaged for purposes of one Participant, their immediate family members, and the Participant itself, may not hold, in the aggregate, more than a 20 percent equity ownership interest in any other single Participant."	SBA interprets this rule as precluding an individual from using his or her disadvantaged status to qualify a firm for the 8(a) Program if he has an immediate family member who has used his/her disadvantaged status to qualify another firm for the program. SBA will clarify this interpretation in the new rule. SBA can waive this prohibition.	We are in favor of the waiver process the SBA proposes to add. As the SBA recognized in the proposed rules, SBA has been forced to deny 8(a) admission to companies solely because the owners of those companies have family members who are disadvantaged owners of other 8(a) concerns, even when the two firms are in different industries and are located in different parts of the country. However, as drafted, the rule seems overly broad as it could place a lifetime ban on immediate family members' abilities to obtain 8(a) certification even many years after the first 8(a) firm has graduated.

13 C.F.R. § 124.106	This rule addresses control of an 8(a) applicant or Participant.	The disadvantaged owner must reside in the U.S. and spend part of every month working in the firm's principal office. SBA has asked for comments regarding whether control should be determined on a case-by-case basis, or should it require physical presence by the individual(s) claiming disadvantage in the headquarters of the applicant or Participant for a minimum amount of time each month.	In SBA's view, the potential for negative control is great when an individual on-site manager is relied on by an absent chief executive. While we understand the SBA's concern, we believe SBA should determine control on a case-by-case basis. As SBA recognized, given the increased use of email, express mail, and new technologies, managers are able to maintain control over the operations of their business without the need for a constant or consistent physical presence.

Key Terms

AGI = Adjusted Gross Income
ANC = Alaska Native Corporation
CDC = Community Development Corporation
HUBZone = Historically Underutilized Business Zone
IG = Inspector General
JV = Joint Venture
MP = Mentor/Protégé
NHO = Native Hawaiian Organization
OHA = SBA's Office of Hearings and Appeals
SBA = Small Business Administration
SDVO = Service-Disabled Veteran-Owned
SOP = Standard Operating Procedure