

# Contentious Debate Looms Over Small Business Venture Capital



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In the parlance of venture capitalists, it's known as the "valley of death," a place that small technology companies fear. No matter how good their science, the valley awaits if they can't bridge the financial gap between the lab and their first commercial product.

In many cases, however, nascent tech firms can bridge the valley by tapping the government's small business programs, which provide everything from loan guarantees and grants to fee waivers for government services. But therein lies the rub. Can a small business still be considered small if it's substantially owned by a venture capital firm with hundreds, if not thousands, of employees?

The question is at the heart of a brewing debate on Capitol Hill that could become one of the most contentious facing small businesses in recent memory. Right now, the correct answer is "no." But a legislative proposal would amend the landmark Small Business Act to make it possible for venture-backed companies to be considered small businesses.

While the measure would be a boon to the venture capital industry, a recent hearing on Capitol Hill previewed just how heated the issue will be. Rep. Steve Chabot, R-Ohio, the ranking minority member on the House Small Business Committee, called the proposal "eviscerating." It would, he said, "drastically change the long-held standard [under the act] that a small business is one that is 'independently owned and operated.'"

Small business advocates are equally up in arms. "I'm violently opposed. It's essentially a partial repeal of the Small Business Act," said Lloyd Chapman, president and founder of the American Small Business League (ASBL). Chapman has long criticized the federal Small Business Administration for allowing large corporations to take advantage of programs earmarked for small firms.

But this time, Chapman has an unlikely ally. SBA Administrator Steven Preston also opposes the change. "The basic premise of small business-size status is circumvented by the provision," he told lawmakers. "We must object."

Normally, such fierce opposition might spell a quick end to the debate. But the National Venture Capital Association, a powerful lobbying force with strong ties to Democrats on Capitol Hill, is spearheading efforts to amend the law. The group represents 460 firms that oversee about 90 percent of all the venture capital under management in the United States.

More significantly, the lion's share of the money (79 percent) is concentrated in just 10 states, according to the Information Technology and Innovation Foundation, a nonpartisan research and educational institute. Heading the list is California, home to House Speaker Nancy Pelosi, who represents the wealthy San Francisco warrens of many high tech moguls. Second on the list is Massachusetts, home to Sen. John Kerry, who chairs the Senate small business committee. It's hard to believe either would brush off such high-powered constituencies.

Venture capitalists, of course, assert that nothing less than the nation's competitive position in the global economy is at stake, not to mention the next big medical breakthrough or technology innovation. The heart of the problem, they say, is the act itself, which was enacted in 1958, a time when tailfins and transistor radios were considered cutting edge.

Under the act, which the SBA is charged with administering, a small business must be "independently owned and operated" with no more than 500 employees "including all employees of all affiliates" to qualify for government programs.

Robert J. More, a partner in Domain Associates, a San Diego-based venture capital company, cited a recent episode to illustrate how the SBA's definition is flawed. A small biotech company with eight employees applied for a waiver the government offers to small businesses to avoid a \$900,000 fee. But the SBA ruled that the company was ineligible because Domain's 34 percent stake in the firm qualified it as an "affiliate." As such, Domain's employees and the employees of all its other holdings were applied to the company, which put it over the 500-employee threshold.

"This process has clearly harmed the kind of small business that the SBA was established to help," More told the committee. "It is clear the SBA does not deal in the real world and, by its actions, is presenting a significant barrier to innovation."

Both Congress and small business advocates, however, have put intense pressure on the SBA to prohibit large firms from obtaining small business contracts, grants, and other assistance by applying through small subsidiaries. As a result the agency has tightened up its interpretation of what constitutes a small business. Preston told the committee the amendment would present a "potential conflict" with the SBA's effort.

"Legitimately, small biotech companies are opposed to this. It puts them at a complete disadvantage when a Fortune 500 company comes in and takes over a small biotech company," adds Chapman.

A committee staffer told me this week that the bill has yet to be introduced because some "kinks" still need to be worked out. Beside the question at hand, the measure, tentatively known as the "Small Business Investment Expansion Act of 2007," contains a lot of technical changes to other small business programs. But my source said it will likely be introduced next week because a committee markup has already been scheduled.

House Small Business Committee Chairwoman Nydia Velázquez, D-N.Y., will most likely sponsor the bill. If it contains the venture capital provision, expect to be hearing a lot more about the "valley of death."