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Report on the United States Small Business Administration

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Report On
/ THE UNITED STATES
SMALL BUSINESS ADMINISTRATION
for the
BUSINESS ADMINISTRATION DEPARTMENT
of
ILLINOIS WESLEYAN UNIVERSITY

Submitted to
Professor Oliver R. Luerssen, Advisor

by
David C. Case
Business Administration Major, Senior

April 23, 1967

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109 East University
Bloomington, Illinois
April 23, 1967

Professor Oliver R. Luerssen
Business Administration Department
Illinois Wesleyan University
Bloomington, Illinois

Dear Professor Luerssen:

A research project was authorized by the Illinois Wesleyan Business Department in the Spring of 1966, in conjunction with my candidacy for Departmental Honors. The report which accompanies this letter is both a record and a product of my research in regards to the research assignment.

The topic which I chose was the United States Small Business Administration. The scope of the report is necessarily broad, for the purpose was to study the services available to small businesses in the United States through the facilities of the Small Business Administration. The information presented here is directed toward the Faculty and students of the Illinois Wesleyan University's Business Administration Department.

Please note that the appendix of the report is a separate addition, due to the legal-size paper enclosed therein, and "end-noting" has been used to footnote sources consulted.

In addition to the sources listed in the bibliography of the report, information for this study was obtained through personal interviews I had in Chicago, Illinois with the Small Business Administration's Area and Regional Directors, the Financial Assistance Director, the Management Assistance Director, and the Small Business Investment Company Director. I also visited the Continental Bank of Illinois, in Chicago for an interview with an officer of Continental's Small Business Loan staff.

Mention should also be made of my appreciation to Senator Everett M. Dirksen, who kindly supplied the reports of the Congressional Investigations into the operations of the Small Business Administration and the Small Business Investment Companies, which were conducted in 1966. His assistance was very helpful.

It is my hope that this report will be informative and useful to you and the Business Department. Please let me know if I can supply any further information.

Sincerely yours,



David C. Case
Senior Business Administration Major

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SECTION I

INTRODUCTION

Problems of Small Businesses in the Economy

America's small business concerns operate in our huge economic complex, along side some very large economic giants. In this economic environment, these small businesses are sometimes confronted with many problems. Foremost among the problems that small business faces are management weakness—involving the lack of management ability, and financial weakness—relating to the lack of adequate capital and credit.

These and other problems sometimes cause some people to claim that small business is dead. However, Robert R. Nathan Associates, after conducting a study of opportunities for small business, reported in 1965 that:

'Small business is not dead, and reports stating such have been greatly exaggerated. Neither economics of scale, nor corporate giantism, nor massive government procurement, nor automation, nor taxation, has reduced the small businessman to insignificance.'

Many opportunities for small business exist; yet, small business is confronted with the resulting inadequacies of smallness in a huge economy.

Creation of the Small Business Administration

Early in the 1950's, the two Congressional champions of small business, the United States House and Senate committees on small business initiated action resulting in the creation of the United States Small Business Administration in 1953. In this report we will be concerned with what the Small Business Administration is doing to aid and promote small business.

Purposes of the Small Business Administration

The Small Business Administration (SBA) was created with the purposes of assisting, counselling, and protecting the interests of small business concerns. It endeavors to insure that a fair share of Government purchases and contracts for supplies is apportioned to small business. It makes loans to qualifying small business concerns and tries to aid small firms in improving their management skills. Finally, the Small Business Administration is responsible for licensing, regulating, and loaning funds to Small Business Investment Companies (SBICs).²

Functions of SBA

The Small Business Administration has four major functions, that originate from the purposes of the agency. They include:

1. Financial assistance
2. Management assistance
3. Procurement assistance
4. Responsibility for Small Business Investment Companies

SBA's programs and activities relating to each of its four major functions will be presented later in this report, after a broad look at the organization and scope of the agency.

Organization of the Small Business Administration

The external organization of SBA is geographically structured. The Small Business Administration has seventy-two offices located in major cities throughout the nation. SBA's head-office is in Washington, D.C.³

Within the agency management is the responsibility of an Administrator, who is appointed by the President with the consent of the Senate and four Deputy Administrators, who are appointed by the Administrator.⁴ On June 30, 1966 SBA personnel totaled 4,106 employees. Of that number, 846 were working in the Washington office.⁵ The Small Business Administration's personnel were responsible for administering \$1,800,000,000 in total cumulative appropriations to SBA's revolving fund, as of June 30, 1966.⁶

SBA's Scope of Activity

According to the Small Business Administration, and the National Federation of Independent Business, two percent of U.S.

small businesses have at some time depended on SBA for aid, especially for financing. When considering all of the organized sources of loan funds or credit, one discovers that of all small businesses two percent depend on the Small Business Administration, twenty-two percent deal with banks, and savings and loans, and seventy-six percent work with suppliers, manufacturers, or others in obtaining needed funds.⁷

Although the percentage of small businesses that have dealt with the Small Business Administration appears to be low, small business is not a small interest group. Depending upon the definitions regarding size, small businesses comprise up to 4.7 million of the nation's 4.9 million business units, or ninety-five percent and employ 30 million Americans.⁸

Now we will consider SBA's programs in relation to its four functions.

SECTION II

SBA'S FINANCIAL ASSISTANCE PROGRAM

The Program in General

Size Definition

If a small business falls within the size definitions set by the Small Business Administration, it may qualify for a loan from the agency. SBA defines a small business as one that "does not dominate its field, and has assets of \$5 million or less, net worth of \$2½ million or less, and average net income of \$¼ million or less in the two most recent years of business."⁹

Loan Characteristics

The Small Business Administration's financial assistance program conforms very closely with the general characteristics of most Government loan programs. Such programs are characterized by:

1. Avoidance of competition with private lenders
2. Emphasis on secured loans
3. Elaborate procedures on loan acquisition and servicing
4. Large proportion of applications denied
5. Uniform interest rates
6. The subsidy element
7. Unique loss experience¹⁰

SBA loans are no exception to these general rules. There are several requirements and restrictions that the Small Business Administration has set in administering its financial assistance program. One important restriction applies to all loans. The agency, by law, can not make a loan if a business can obtain funds from a bank or any other private source. Therefore, in cities of 200,000 or more, a business or individual must be turned down by two banks before applying to SBA for a loan. In addition, applicants are required to comply with SBA regulations that "there will be no discrimination in employment or services to the public, based on race, color, or national origin."¹¹

Loan Restrictions (Ineligibility)

The Small Business Administration's position is clear in regards to restricting its lending. SBA says that "because it is a public agency using taxpayers' funds, it has an unusual responsibility as a lender." For this reason, certain applications are rendered ineligible. The Small Business Administration will not make business loans under these conditions:

1. If the funds are otherwise available on reasonable terms
2. If the loan allows speculation in any kind of property
3. If the applicant is a non-profit enterprise
4. If the loan finances recreational or amusement facilities, unless the facilities contribute to the health or general well-being of the public
5. If the applicant is a newspaper, magazine, book publishing company, radio broadcasting company, or similar enterprise
6. If fifty percent or more of the net sales of the applicant is derived from the sale of alcoholic beverages
7. If any of the gross income of the applicant (or any of its principal owners) is derived from gambling activities
8. If the loan provides funds to an enterprise primarily engaged in lending or investments
9. If the loan encourages monopoly or is inconsistent with the accepted standards of the American system of free competitive enterprise
10. If the loan finances real property that is, or is to be, held for sale or investment
11. If the loan is used to relocate a business for other than sound business purposes.¹²

Loan Requirements

In addition to the loan restrictions, the Small Business Administration has established general credit requirements.

They state that the loan applicant must:

1. Be of good character
2. Show ability to operate his business successfully
3. Have enough capital in the business so that with an SBA loan he can operate on a sound financial basis
4. Show the proposed loan is of sound value
5. Show that the past earnings record and future prospects of the firm indicate ability to repay the loan and other fixed debt, if any, out of income
6. If the venture is a new business, be able to provide from his own resources approximately half of the total required funds.¹³

The Small Business Administration administers seven important loan programs to provide financial assistance to small business. Next, each type of loan will be presented separately.

Business Loans

First among the seven types is the Business Loan. This loan is the best known of all of SBA's loans and is the strength of the financial assistance program as a whole.

Use of the Funds

This type of loan is made to provide working capital or to finance construction, expansion, machinery, equipment, facilities, supplies or materials.¹⁴

Maximum Maturity

The maximum term of the loan is ten years, plus the amount of time needed for construction. One exception, however, is working capital loans, which are granted for a maximum term of six years.¹⁵

Loan Amount and Bank Participation

The Small Business Administration may make the loan itself or it may, if possible, enlist the cooperation of a bank to participate in making the loan to an applicant. In either case

the amount of Government funds that may be committed to one borrower is limited to \$50,000; but, the total amount of the loan can be up to \$100,000 if a bank participates with SBA in making the loan.¹⁶

Interest Rate

The Small Business Administration charges five and one-half percent interest on its share of these loans. If a bank participates in making the loan, the bank may charge its normal rate of interest on its share of the loan.¹⁷

Required Information and Servicing

Primarily, the information required by SBA in its Business Loan application forms includes:

1. Purpose of the loan
2. Balance sheet of the business
3. Income statement of the business
4. Collateral offered
5. Three-year forecast of earnings
6. Personal financial statement of the individual or individuals applying for the loan
7. Personal history of the individual or individuals applying for the loan
8. Declaration that the applicant will comply with the non-discrimination requirements in Title VI of the Civil Rights Act of 1964
9. And the number of employees now employed by the business and the additional number that will be employed as a result of the loan. (See appendix)

According to the Financial Assistance Director at SBA's Chicago field office, it takes about ten days to process a business loan application—assuming that the applicant has properly filled out the necessary forms and accepts all of SBA's terms regarding collateral, etc.

Risk Evaluation

In evaluating the risk and potential repayment possibilities on Business Loans, the Small Business Administration uses some publications commonly employed by banks and other lenders to make credit appraisals. According to the Financial Assistance

Director at Chicago, these include:

1. Barometer for Small Business, published by the Accounting Corporation of America—regarding retail and service industries,
2. Robert Morris Associates, published by the National Association of Bank Loan Officers, for manufacturing companies,
3. Key Business Ratios and Failure Records, published by Dun and Bradstreet, Inc.—covering proprietorships and partnerships.

Closing Fee and Interest Escalation

If a Business Loan is approved, there is a closing fee amounting to the greater of either \$10.00 or one-eighth of one percent of the amount of the loan provided by the Small Business Administration.¹⁸

In addition, if a bank originally participates with SBA in making the loan and later decides to purchase SBA's share of the total loan, there is an interest escalation provision that permits the bank to raise the interest rate on the purchased loan up to $7\frac{1}{2}$ percent per year.¹⁹

Average Loan Size, Loss Rate, and Approvals

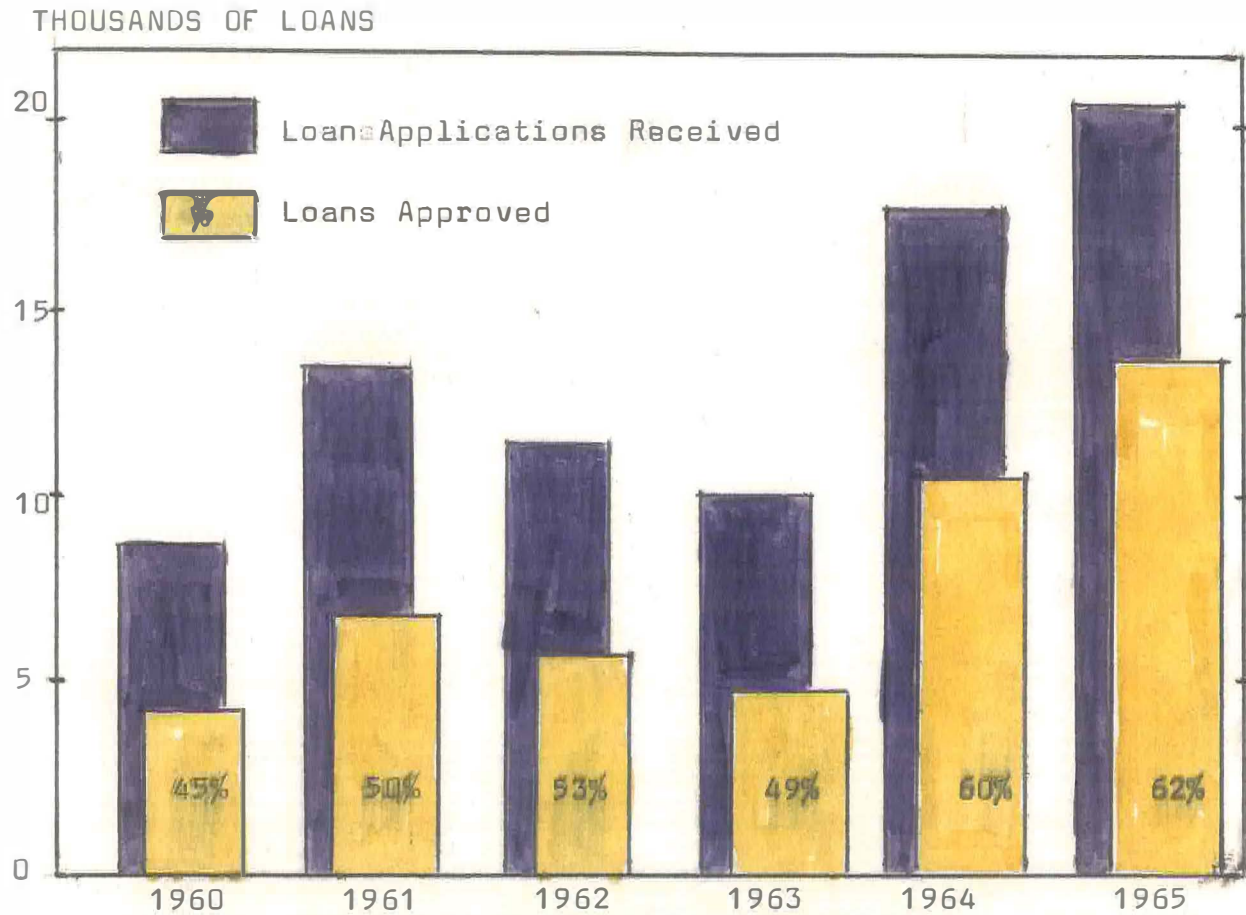
During fiscal year 1966 the average size loan was about \$34,000; but, the accumulative average loan size for all years is about \$43,800. The average loan term was for 77 months. The loss rate on SBA's share of all loans is 2.6 percent. In addition, banks have participated in almost sixty percent of the number of loans that have been approved.²⁰

Incidentally, a schedule of all Business Loan approvals, by year, is available from the Government Printing Office. It lists the amount of each loan, the names of businesses receiving the loans, and their location by city and state.

Since the birth of the Business loan program until June 30, 1966, 64,260 loans were approved involving \$2,849,800,000 of SBA and bank money. The chart on the next page (Business Loans-Applications Received and Approved) illustrates recent loan approval rates. The approval rate increased to sixty percent in 1964 and 1965 due to an SBA policy change, emphasizing smaller loans.²¹

Figure 1

BUSINESS LOANS
APPLICATIONS RECEIVED AND APPROVED
CALENDAR YEARS 1960-1965



Supporting Schedule

NUMBER OF APPLICATIONS					
YEAR	REC'D	WITHDRAWN	DECLINED	APPROVED	PENDING AT YEAR END
1960	8,853	722	3,899	4,012	1,063
1961	13,680	881	5,526	6,836	1,500
1962	11,245	909	5,135	5,953	748
1963	10,004	724	4,337	4,975	716
1964	17,854	950	5,149	10,707	1,764
1965	20,409	1,357	6,465	13,506	851

Source: Small Business Administration 1965 Annual Report, p.15.

Loan Priority System

Because of the Government's national goals and the war in Vietnam, the Small Business Administration recently adopted a loan priority system as follows:

1. Loans to businesses located in areas cited for substantial or persistent unemployment in the Department of Labor report.
2. Loans to businesses which reduce the balance-of-payments deficit through export sales.
3. Loans to businesses which contribute toward the achievement of precise national goals such as:
 - a. Business necessary to Government procurement activities.
 - b. Businesses that contribute to reducing air or water pollution.
 - c. Businesses that contribute to the development of Federally owned recreation lands.
4. Loans in the public interest, based on local needs, which clearly help to strengthen the local economy by providing a needed service, product, facility, or significant new business or employment opportunities.²²

SBA's Administrator has said, in regards to the priority system:

We are not in the affluent position of having the money to finance every deserving loan application that comes to us. We have to be selective; we have to look for the opportunities that are going to be the most helpful.²³

The priorities of the priority system are not necessarily absolute in practice, but they are considered seriously depending upon the nature and reason for the loan, and the economic environment of the area which the SBA office serves.

Local Development Company Loans

Second of the seven types of loans available under the Financial Assistance Program are SBA's Local Development Company Loans, which were first made in 1959.

Financing Procedure

These loans are made to local and State development companies, organized by groups of citizens to undertake an economic project

in their communities, using the funds to finance specific small firms in the local area.

The Small Business Administration will loan a Development Company eighty percent of the funds needed for a project, if the Company provides twenty percent. This is a four-to-one match of Government to private funds.²⁴

SBA may loan up to \$350,000 to a Development Company for a maximum term of twenty-five years at five to five and one-half percent interest. The Development Company can use the funds to buy land, build a factory, acquire machinery and equipment, or to construct shopping center space for small businesses.²⁵

Development Loan-Example

As an example of how the Development Company Loan can work, below is a brief study of one SBA loan, taken from SBA's 1965 Annual Report:

Early in 1965 the town of Kezar Falls, Maine, was prematurely sentenced to death. The owners of the local woolen mill—the economic mainstay of the community for generations—decided to close their plant and liquidate their holdings. The mill employed 250 of the town's 869 residents. Its closing would mean Kezar Falls's doom.

Yet the plant was closed. The sale price was put at \$450,000. The people of Kezar Falls knew their only chance to keep their town alive would be to buy the plant. A fundraising drive netted \$55,000. This was far short of the amount needed but the plant owners accepted it as a deposit and gave the townspeople 120 days to raise the remainder.

At the same time, a small New Hampshire woolen mill expressed interest in a long-term lease on the plant. It wanted to expand its operations. The people of Kezar Falls formed the Parsonfield Development Corp. and approached SBA for help. SBA approved a development company loan for \$350,000 for the corporation. A local bank then loaned the corporation \$45,000. The cost of the mill was met.

The mill is operating again. It employs 192 people and has an annual payroll of \$728,000. Within a short time, about 300 persons—nearly one-third of the town's population—are expected to be employed by the plant.²⁶

Incentives and Initiatives

Collateral on a Development Company loan is usually a first mortgage on the project being financed. Banks are encouraged to participate with the Small Business Administration in making a loan, for if a bank takes a forty percent share of the loan, SBA will award a first mortgage on the project to the bank. If the bank will take the entire loan, SBA will give it a ninety percent guarantee against any losses.²⁷

The degree of bank participation is usually high. As a result, while SBA regulations permit the ratio of Federal to private dollars to be four to one, the current ratio is only two to one. Community interest has been a motivating force and has led to the more extensive use of private funds. The loss rate on these loans is averaging only two-fifths of one percent,²⁸ on 983 loans approved since 1959 for over \$155,800,000.²⁹

Economic Opportunity Business Loans

The third type of loan that SBA is authorized to make is the Economic Opportunity Business Loan. Before 1964, the Small Business Administration had a special loan program, termed the "six-by-six". It offered \$6,000 for up to six years to operating businesses and proposed new businesses.

However, the "six-by-six" loans were superceded, in 1964, by the Economic Opportunity Business Loans—authorized by Title IV of the Economic Opportunity Act of 1964.³⁰

Nature of the Program

Essentially the program functions, under the Act, to provide "poverty" loans. The program is carried out exclusively in larger cities, and primarily in areas that are experiencing concentrated poverty problems.³¹ Most of the loans are made to people with very low incomes, who want to go into business, or who are presently in business.

In its 1965 Annual Report, the Small Business Administration stated that "Most [of the applicants who received loans] lived in city slums. About forty percent were Negro."³²

For SBA's lending purposes, poverty is currently defined as ranging from \$4040 or less of income per year for a single person, to \$7590 for a family of seven.³³

Provisions of the Program

Qualified applicants can get loans of up to \$15,000 for a maximum of fifteen years. The interest rate is four percent in very depressed areas; otherwise, it is five and one-half percent.

Collateral on the loan is required if it is available; but SBA will rely on the applicant's character, skills, and ideas for security, if there is reasonable assurance that the loan will be repaid.³⁴

Loan Volume and Losses

By June 30, 1966 the Small Business Administration had made \$19,400,000 in Economic Opportunity Loans.³⁵ At that time the program was only two years old, and SBA had not estimated what its losses on the loans would be. However, the Administrator, as reported in "Barrons" Business and Financial Weekly, said that he "...won't be surprised if the loss ratio on poverty loans could run as high as 7% in fiscal 1967."³⁶

Administration of the Program

Although the funds for Economic Opportunity Loans are supplied by SBA, the loans are made only at Small Business Development Centers (SBDCs), located in the heart of the problem areas. The program is administered primarily by the Office of Economic Opportunity, which sets eligibility requirements and bears most of the administrative costs.³⁷

DISASTER LOANS

Disaster Loans are the fourth type of loan available under the Small Business Administration's Financial Assistance program. These loans are unique because they are the only loans that SBA makes to home-owners, churches, and privately owned institutions as well as businesses.³⁸ However, this program does not cover farmers and stockmen, as they are covered through the Farmers

Home Administration.³⁹

With the above exception, those who suffer damages from hurricanes, floods, or other natural disasters are eligible to receive loans to restore or replace their property. The maximum maturity is thirty years and the interest rate is three percent. The amount of the loan is limited to the actual sustained loss, less any insurance payments received. Collateral is required, if any exists.⁴⁰

The loan volume under this program was extremely heavy in 1965. Due to hurricane Betsy in early September, 26,310 loans were approved in 1965 for a total of \$206,900,000. The number of loans made in that year exceeded the number made in all previous years.⁴¹ Presently the loss rate on these loans is about 3.1 percent.⁴²

Other Loan Programs

Compared to the nature and volume of the four loan programs presented above, the following three types of loans are less important. Therefore they will be given abbreviated attention.

Economic Injury Disaster Loans

These loans are made to small firms that have suffered substantial economic injury because of a major disaster—the same as with the Disaster Loans; but, they are limited in that they are made to finance working capital and inventories.⁴³

The loans have maturities of up to a maximum of thirty years. The interest rate is three percent and collateral is required.⁴⁴

Displaced Business Loans

Displaced Business Loans are made to small firms that have suffered economic losses because of their displacement as a result of Federally-aided urban renewal, highway, and other construction programs. The loans can be used to re-establish and to make some reasonable improvements on the business.

The maximum maturity is thirty years. The interest rate is currently four and one-quarter percent, and collateral is required.⁴⁵

Product Disaster Loans

Last are the Small Business Administration's Product Disaster Loans. They are made to small firms that have suffered substantial economic injuries as a result of being unable to process or market their products because of spoilage. These loans are made primarily to provide working capital so that the firm can continue in business. Again, the terms are three percent interest, thirty year maximum maturity, and collateral is required.⁴⁶

SECTION III

SBA'S MANAGEMENT ASSISTANCE PROGRAM

Program Policy and Emphasis

The Small Business Administration's second major function is to provide management assistance. According to SBA's Management Assistance Director at the Chicago field office, it is SBA's policy to act as a motivator or catalyst for management assistance, and to help small businessmen obtain management ability, first, and financial assistance, second—whenever possible. Further, as a matter of policy, it is not the intention of the Small Business Administration to compete with private counselling agencies, but rather to help small firms that can not afford private services in this field.⁴⁷

Service Corps of Retired Executives

Probably the greatest single stride forward in SBA's Management Assistance Program has been made through the Service Corps of Retired Executives (SCORE) Program. Thus far, some 3,000 executives have volunteered their time and effort to help small businesses through the Small Business Administration. Some of the SCORE volunteers are well known ex-presidents and officers of highly respected companies. They donate their help, generally at no cost, to small businesses employing less than twenty-five workers. To date SCORE volunteers have helped some 10,635 small firms, since the program was started in 1964.⁴⁸

This group, with its 138 chapters throughout the nation, has an entire staff equaling, in size, almost three quarters the total number of employees working for the Small Business Administration. The Service Corps of Retired Executives has provided much of the personal attention that SBA could not have made available otherwise. Business Week magazine points out:

If this service had not been instituted for people in distress, the SBA might at best have referred a businessman to its loan department or made more invitations to attend the monthly workshops on management techniques; it would not have had the manpower to offer individual attention. 49

Further, Business Week points out that the primary reasons for SCORE's success are that:

1. It offers an outlet for the pent-up energies of the nation's fastest growing bank of talent—retired executives.
2. It offers small businessmen, without charge, the commodity that it may well be shortest of—objectivity. 50

In addition to the SCORE program, the Small Business Administration conducts other activities, including workshops, problem clinics, its own counselling program, and sponsors joint-cooperation programs with universities, night-schools, and trade associations.

Trade associations are paid by SBA to produce articles for small business which are designed with the self-appraisal and self-help approach. In 1965, 4.3 million copies of those articles were distributed to small businessmen. Some are sold at nominal prices and the others are free. 51

Intra-Industry Management Program

The Small Business Administration sponsors a management assistance program called "IMP"—Intra-Industry Management Program. Here SBA works with large corporations and trade associations to devise management training programs for client or member retailers. According to the Chicago Management Assistance Director, the program has worked well particularly

in its regional activities in cooperation with RCA, Whirlpool, Hot-Point, and Allis Chambers.

A small business that participates in the Intra-Industry Management Program can get advice from large companies and trade associations on:

1. Record keeping services
2. Advertising
3. Effective selling
4. Credit and collections
5. Personnel
6. Finance
7. And store location and layout.⁵²

Problem Clinics and Export Development

An area which the Small Business Administration is developing is the Problem Clinic. The problem clinic is an area where general trade groups attempt to find ways to develop money-making shortcuts such as side-line products and standardized buildings and fixtures, etc.

Finally, SBA conducts export development programs for small business, in coordination with the U.S. Department of Commerce.⁵³

SECTION IV

SBA'S PROCUREMENT ASSISTANCE PROGRAM

Nature and Purpose

As stated earlier, on page two, the Small Business Administration endeavors to insure that a fair share of the total Government purchases and contracts for supplies is apportioned to small business. In 1965 SBA combined its procurement and management assistance activities in order to eliminate duplicating or overlapping activities, and to effect faster service in its programs to help small businesses sell to the Government.

SBA's activities in the Procurement Assistance Program are primarily directed toward motivating other Government agencies to reserve purchases and contracts for small business. SBA also

issues 'certificates of competency' to small firms desiring contracts with the Government.

Set-Aside Programs

Prior to 1965 the Small Business Administration conducted a joint set-aside program with the Defense Department and other major Government agencies. SBA set minimum goals for awards of contracts to small business and reviewed purchasing policies of many Government agencies. However, in 1965 SBA decided that post-facto review was not working well. With the consent of the Defense Department and the Bureau of the Budget, the Small Business Administration switched its program to a unilateral set-aside arrangement, calling for Government agencies to voluntarily reserve as many contracts as possible for small business.⁵⁵

Perhaps the greatest reason for the switch to the unilateral set-aside program was the tremendous amount of resistance from the Defense Department to SBA's goals in the joint set-aside program.⁵⁶

With the unilateral set-aside program, many contracts are reserved and awarded to small business. Further, in 1966 for example, 41.7 percent of the contracts awarded to large businesses were sub-contracted to small businesses.⁵⁷ Regarding this voluntary reserve program, the Director of the Bureau of the Budget reported to Congress in 1966 that small business was receiving a full share of the increased procurement in the defense area.⁵⁸

Certificates of Competency

The Small Business Administration issues "certificates of competency" to some small businesses, as one of its procurement activities. They are explained in SBA's 1965 Annual Report.

Any small business submitting the lowest bid on a Government contract which finds its ability to fulfill the contract under question by the contracting officer may appeal to SBA. SBA will study the firm's productive capacity, its ability to obtain needed production equipment,

space and specialized personnel, and its financial resources. If SBA finds the firm can fulfill the contract, the agency awards a 'certificate of competency' for that specific contract. This certification usually brings the small firm the award. ⁵⁹

Cummulatively through 1965, the Small Business Administration received a total of 4,231 applications for certificates. Of those, 1859, or somewhat less than half, were approved. ⁶⁰ In 1965, alone, SBA received 517 applications and approved 220. Of the 220 certificates awarded, 199 were accepted by government agencies and the contracts were awarded. ⁶¹

The Small Business Administration ^{SAYS} that the contracts awarded, during 1965, as a result of "certificates of competency" saved taxpayers \$4,000,000, because small firms were low bidders on the contracts involved. Based on SBA's administrative expenses for that year, of which \$1,002,625 went toward handling applications for "certificates of competency", the net savings to the taxpayer was approximately \$3,000,000. ⁶²

Other Procurement Services

Contracts Information

The Small Business Administration attempts to help small businesses by assisting them to take part in the bids on Government contracts. As an information service, SBA publishes a list of available contracts in the Commerce Business Daily. ⁶³

"Extra Effort" Program

Since 1963 the Small Business Administration has had a program called "extra effort" designed to help small firms get subcontracting work from large prime contractors. The large contractors are encouraged by SBA to work with the agency in reviewing their contracts and in finding small firms to take subcontracting work. ⁶⁴ The new Federal Building in Chicago was partly subcontracted to small firms for construction through the "extra effort" program.

Currently 39 large companies are participating in the "extra effort" program. The companies account for sixty-two percent of Defense Department spending. To aid these companies

and Government agencies in distributing contract work, SBA has a computer data inventory of some 64,000 small firms.⁶⁵ Together the firms in the inventory account for 11,000 different product lines and manufacturing processes, 143 construction activities, and an assortment of research and development capabilities.⁶⁶

Government Surpluses

Finally, the Small Business Administration is able to help small firms to get some of the equipment and materials that they need, from Government surpluses. Sometimes small firms can get available Government surpluses at thirty percent, or less, of original cost.⁶⁷

SECTION V

SMALL BUSINESS INVESTMENT COMPANIES (SBICs)

Creation of SBICs

Purpose of SBICs

The Small Business Administration's fourth major function is to administer the Small Business Investment Company (SBIC) program. SBICs were established by Congress in 1958. The purposes as set forth in the Small Business Investment Act were to:

Improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization,⁶⁸ and which are not available in adequate supply.

Need for SBICs

Small Business Investment Companies were created primarily to supplement SBA's financial assistance programs. Until 1958 the Small Business Administration could provide only loan funds to small businesses. Some vehicle was needed to provide

capital funds. The SBICs were created to remedy the situation. The 1958 Act, and its subsequent revisions, established the SBIC program under the authority of the Small Business Administration in a division known as the Small Business Investment Division.⁶⁹

SBA's Authority and Responsibility for SBICs

The Small Business Administration is authorized to license, regulate, examine, loan funds, delicense, and issue cease and desist orders to SBICs.⁷⁰ Since the total appropriation for the Small Business Investment Company program is \$400 million, the SBIC program accounts for about one-fifth of the Small Business Administration's programs as a whole.⁷¹

Nature of SBICs

Definition of an SBIC

A Small Business Investment Company is defined by SBA as "a privately owned and privately operated small business investment company which has been licensed by the Small Business Administration to provide equity or venture capital and long-term loans to small firms."⁷² SBICs do not fall under state banking laws, because they are not essentially banks. However, they must observe state laws limiting interest rates.

Formation of an SBIC

Small Business Investment Companies are started in the following manner. First, a group of private investors apply to the Small Business Administration for a license to operate an SBIC. They must be ready to invest a minimum of \$300,000 in cash or eligible government securities as stockholders in the proposed SBIC, and they must have a plan of operation, and must present to SBA a proposed staff, with which to do an adequate job of operating an SBIC.

As soon as the investors are approved and licensed by SBA, they can start into business as an SBIC. The SBIC can then grow quickly by selling a maximum of \$300,00⁰ in subordinated

debentures to the Small Business Administration. The debentures carry a five percent interest provision, mature in twenty years, and provide that payments start after ten years.

In addition to the leverage obtained by selling the debentures to SBA, the Small Business Investment Company may qualify for another loan from SBA, called an "operating loan", using its assets as collateral, for up to another \$300,000. The maturity on this loan is fifteen years and the interest rate is five and one-half percent. This second loan is supposed to give the SBIC added funds on which to operate and to cover the expenses of getting started.

In effect, a new SBIC can receive \$600,000 in loans from the Small Business Administration on its initial private investment of \$300,000, a two-to-one leverage advantage, and thus have a total of \$900,000 with which to operate. An SBIC may further issue additional stock to private investors, and may borrow from sources other than the Small Business Administration if the ratio of outstanding indebtedness to paid-in-capital and surplus does not exceed four-to-one.⁷³

SBIC Operations

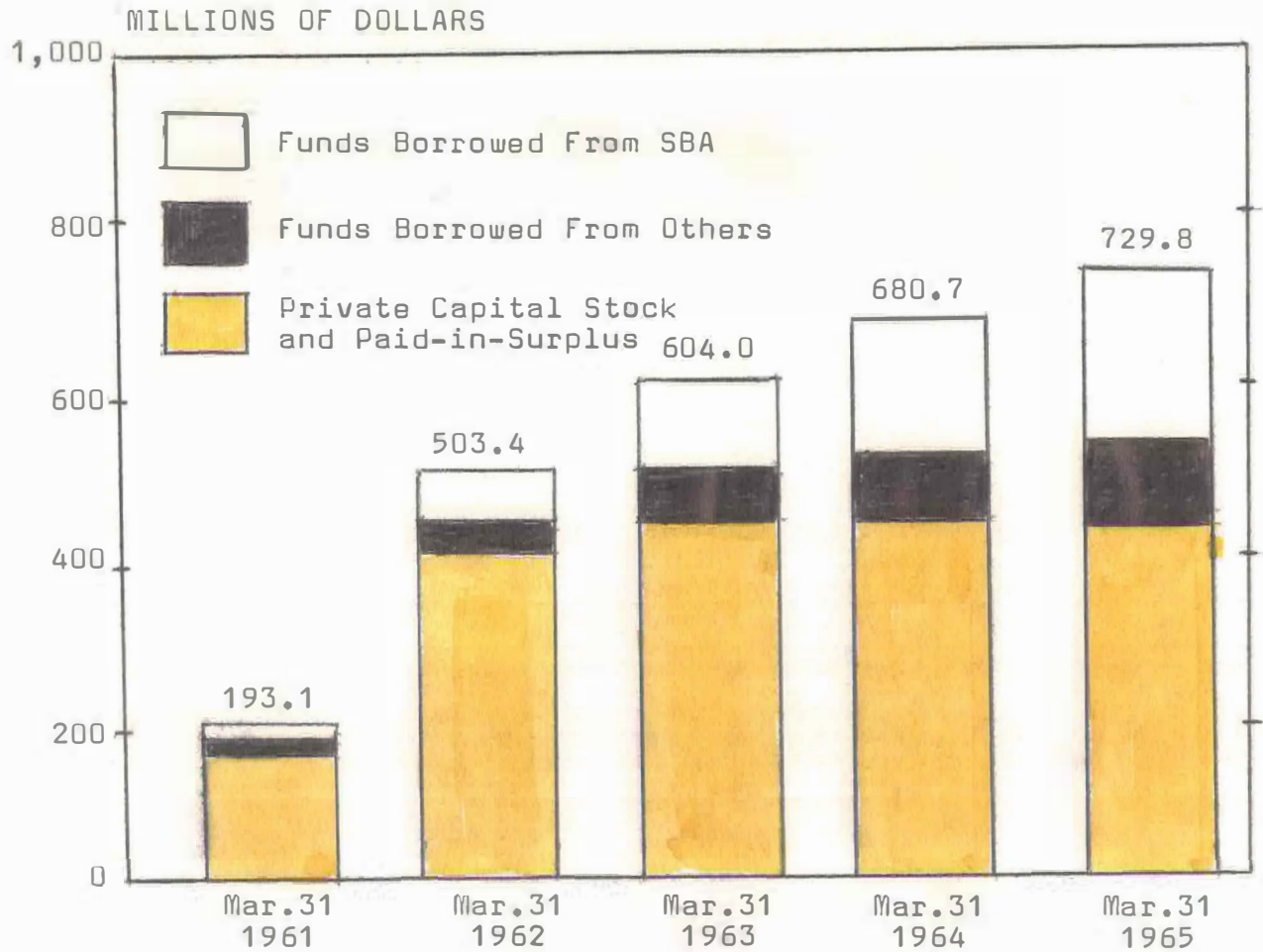
Sources and Utilization of Funds

Once established, an SBIC can operate generally or may specialize in supplying long-term loans and equity to certain industries, such as electronics. But the operators of an SBIC must now agree that investments in real estate companies will not exceed one-third of the SBIC's investment portfolio, due to the highly speculative nature of such investments.⁷⁴

The charts on pages twenty-two and twenty-three illustrate the sources and disposition of Small Business Investment Company funds at the end of the first quarter of 1965. At that time, SBICs had relied upon the Small Business Administration for about forty percent of their funds. Of their total funds, they had invested about three-fourths in small businesses, and were holding their other funds as cash and government securities.

Figure 2

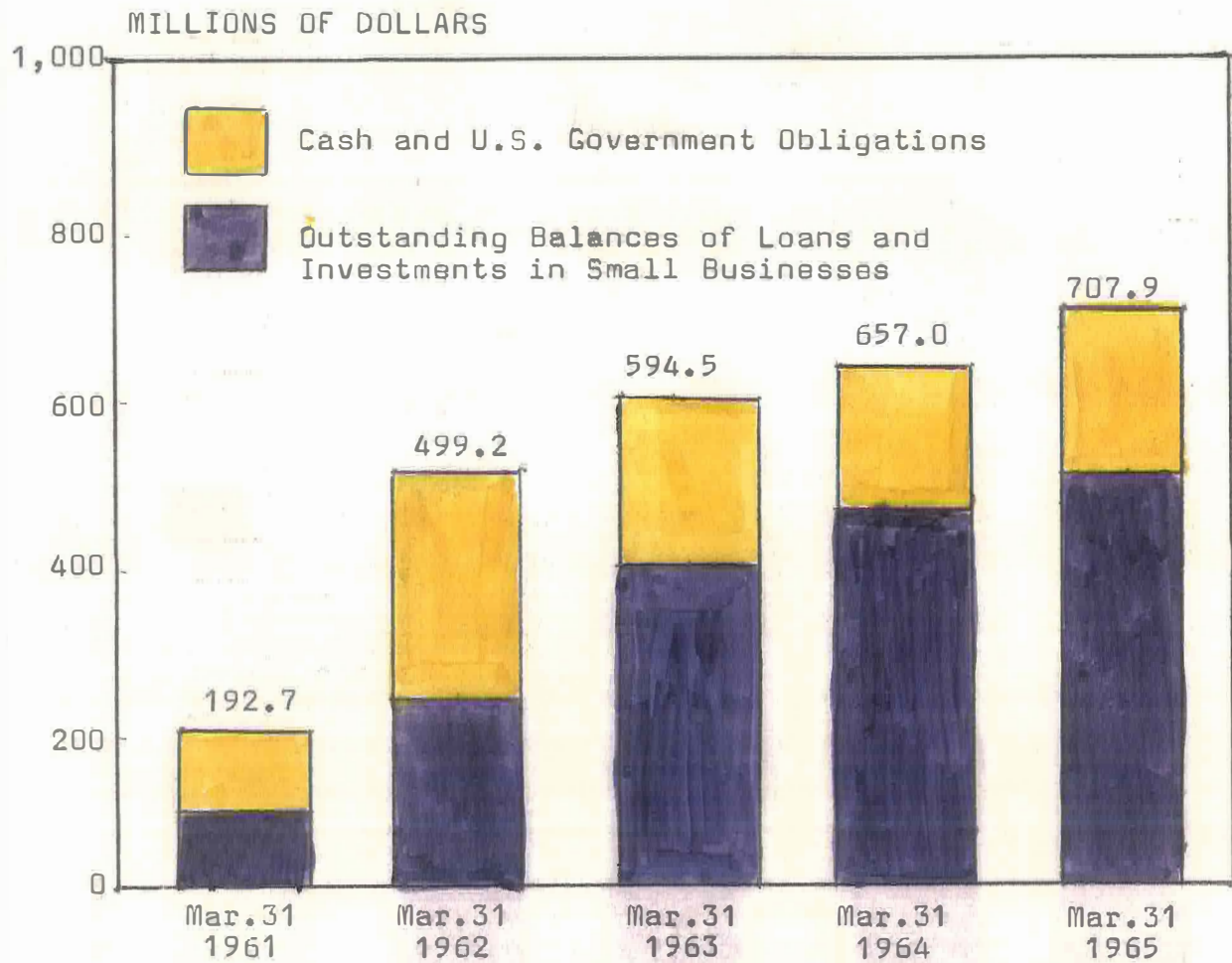
SOURCES OF SBIC FUNDS



Source: Small Business Administration 1965 Annual Report, p.21.

Figure 3

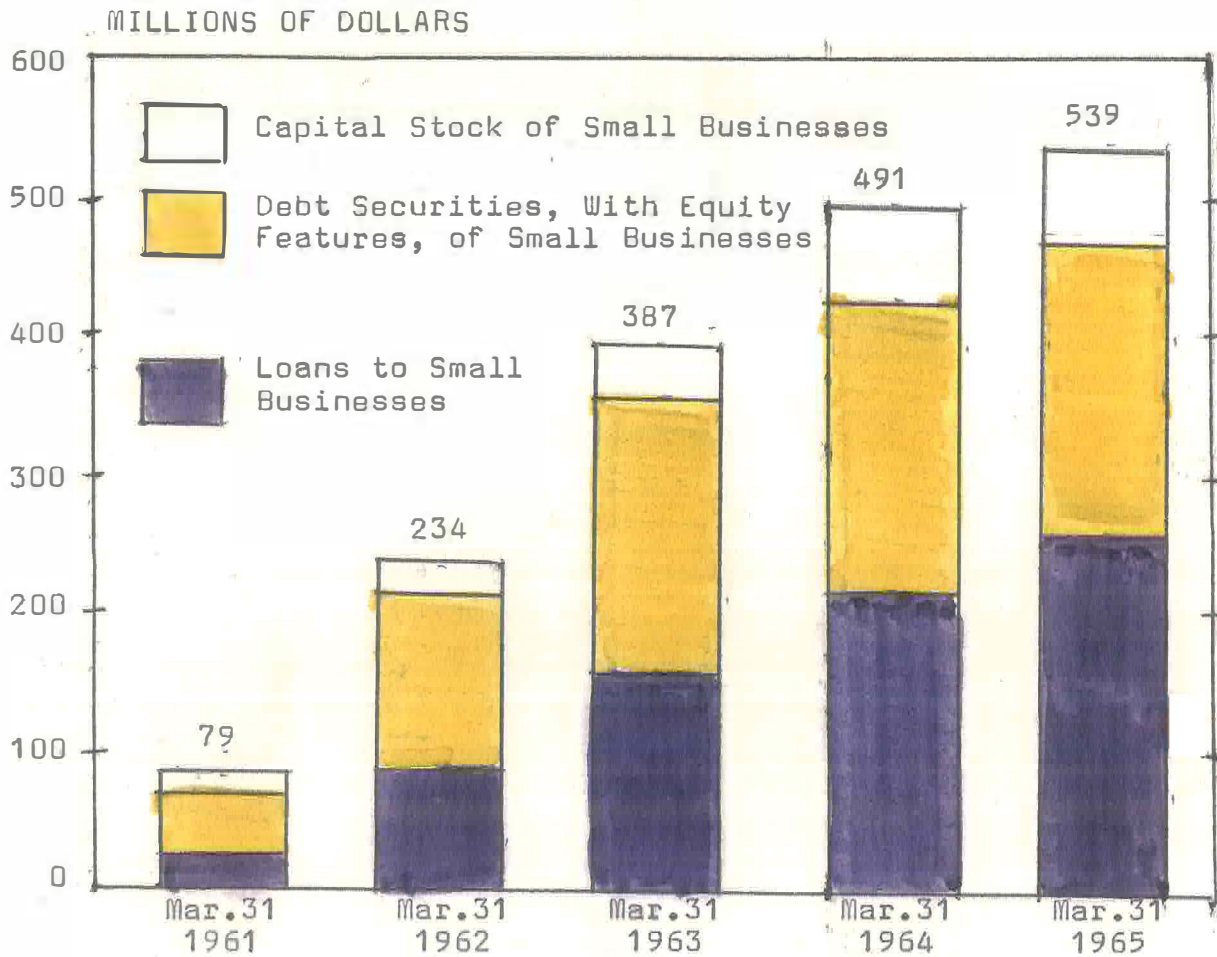
SBIC INVESTMENTS AND UNINVESTED FUNDS



Source: Small Business Administration 1965 Annual Report, p.22.

Figure 4

SBIC GROSS LOANS AND INVESTMENTS



Source: Small Business Administration 1965 Annual Report, p. 23.

Investment of SBIC Funds

A Small Business Investment Company is allowed to invest up to twenty percent of its private capital in a single business.⁷⁵ For the smallest SBIC this amounts to \$60,000; for the largest, it can amount to well over \$1,000,000. The SBIC may invest in a small business by buying its stock or it may make a long-term loan to the business ranging from five to thirty years, at up to fifteen percent interest.⁷⁶ The firms applying for financing to SBICs are usually rejects from commercial banks; however, a small business does not have to be rejected by a bank to be eligible for SBIC financing.⁷⁷

The chart on page twenty-four shows that of the funds that were invested by SBICs, loans to small businesses comprised about seven-eighths of the total. Capital stock ownership accounted for only about one-eighth of the funds on March 31, 1965.

SBIC Stock-Advantages and Disadvantages

Some Small Business Investment Companies have operated successfully and have even been able to sell their stock publicly. SBIC stock ownership can be very attractive to certain investors. SBICs are a unique form of business organization for four reasons:

1. They are an institutional source of equity capital (and long-term loans)
2. They also have unusual tax status
3. They are able to gain great financial leverage almost immediately
4. They exist under the authority of SBA, a government agency.⁷⁸

The greatest advantage of Small Business Investment Companies to investors, according to the Chicago SBIC Director of the Small Business Administration, is the leverage available through SBA debentures and operating loans. The greatest disadvantage, on the other hand, is that when fifty percent of an SBIC's private capital and surplus is lost, then the SBIC is "impaired" by SBA regulations and the debentures may immediately be called for payment in full.

In addition to the leverage advantages of an SBIC, there are the tax advantages to those who hold SBIC stock. Fortune magazine has excellently summarized both the advantages and disadvantages of SBIC stock ownership:

The appeal to individual investors is maximized by a special feature of the 1958 law. It provides that an investor who sustains a loss, either long or short term, of any size, can treat it as an offset against regular income; if he makes a gain however, it is treated as an ordinary capital gain. (Losses on ordinary common-stock transactions can be offset against income only to the extent of \$1,000 a year.)

This makes the tax provision combined with the speculative nature of the stock or investment and the fact that only about one-fourth of the SBICs pay dividends, makes their shares suitable primarily for the wealthy. Herman E. Goodman, President of the Franklin Corporation, a large publicly held SBIC, suggests the 42% tax bracket as the point at which the advantages of the investment begin to outweigh their special problems. For taxpayers filing joint returns, this means at least \$32,000 of taxable income.

The special problems begin with the fact that SBIC's are rather difficult to evaluate. The customary investor's gauge, earnings per share, is hard to apply to the bulk of publicly held SBICs. Only a few of them have operating earnings as their chief goal. The great majority of publicly held SBICs invest in small companies primarily for capital gains, and try to draw only enough operating income to meet their own expenses. 79

To supplement Fortune's summary, it should be added that regarding the valuation of SBIC stock, it has been pointed out that no more than thirty individuals in this country are qualified to determine the "going concern value" of SBICs. 80

Also, in regards to tax status, losses may qualify as an offset against ordinary income; but, to qualify Fortune's statement, only up to a maximum of \$50,000 per year when filing jointly. 81

Problem Companies

Lately, the Small Business Administration has been criticized, because of the 686 SBICs operating on June 30, 1966, 237 were classified by SBA as being "problem companies."

Problem Classifications

In regards to the problem companies it was reported to Congress that:

24 were inactive
 37 were about to surrender their licenses
 44 had lost at least half their private capital
 76 were being sued or investigated by SBA
 56 had significantly violated SBA regulations 82
237

Approximate Losses

As a result of the problem companies, SBA estimated on April 30, 1966 that it was likely to lose about \$18,000,000 of the \$68,500,000 it had loaned to those companies. At that time, SBA had nearly \$300,000,000 invested in the total SBIC program; therefore, the loss rate was expected to be about six percent. 83

One of the unsuccessful SBICs that was also included in the loss figures reported by the Small Business Administration was the Bloomington Investment Corp of Bloomington, Illinois. 84

Reasons for Problems

According to the Small Business Administration, the major reasons for the problems that have arisen are that about three-fourths of the "problem companies" were minimum sized, single-owner, real estate investment companies that experienced great operating difficulties, while SBA had severe administrative problems of its own in regulating, examining, and investigating the SBICs. 85

SECTION VI

CONCLUSION

Growth of the Small Business Administration

The United States Small Business Administration, as an independent agency of the Federal Government, is no longer an Infant. Although it has existed only fourteen years, dollar-wise it grew quickly from its original revolving fund appropriation of \$50 million in 1953⁸⁶ to one billion, 800 million in 1967.⁸⁷ By June 30, 1966 it had approved almost three billion dollars in business loans⁸⁸ and had made over another one billion dollars of funds available to small businesses, through Small Business Investment Companies.⁸⁹

SBA has assisted about two percent of our small businesses, as stated in the introduction. In regards to the size of the Small Business Administration's effort its new administrator has stated that "in terms of National needs and total demand, our programs are small. They always will be. However, we can not allow them to become routine operations. We must constantly seek to apply them with maximum effectiveness."⁹⁰

Criticisms and Defenses of SBA

In regards to the effectiveness of the Small Business Administration, SBA has been called a failure and a waste by some sources. Those that have criticized SBA have said that the Small Business Administration has not justified its existence; its operation is costly and its losses have been too great; its impact on small business problems has been negligible;⁹¹ and the SBICs have been very disappointing.⁹²

On the other hand, those that defend the efforts of the Small Business Administration have pointed out that Small Business has no other real representation in Government as other interest groups; there has been a tremendous growth in the demand for SBA's services; SBA's appropriation bill had the least cut of all Federal agencies last year, even with our military involvement in Vietnam; and the Small Business Investment Companies are recovering.⁹³

The Fundamental Nature of SBA

All arguments aside, the Small Business Administration is a political creation. This is the one thing, above all others, that limits SBA's effectiveness. The Small Business Administration exists within the framework of a political structure. From that same structure, with its voting and power disparities, stems SBA's raison d'être, the rules under which it must work, and the money with which to carry out its programs.

Naturally, this has affected even the design of the Small Business Administration's programs. For instance, its loan programs have the typical governmental characteristics and its procurement activities are somewhat tailored to political ideals. Priorities in lending have been established that coincide with the Administration's National objectives and one loan program—the Economic Opportunity Loan program—is distinctively flavored with the spices of bigger objectives, such as the "War on Poverty."

Yet, even with its limitations the goal of SBA, as of any organization, is to operate efficiently in its given environment. Has the Small Business Administration been successful in that respect? This is an important question. But further, we are asking if SBA is doing an effective job in regards to its Congressional mandate, of aiding small business. Due to the great variety of SBA's programs, it is not possible here to evaluate each aspect of the Small Business Administration. However, a few general comments can be made.

Summary Comments on SBA

Reason for Existence

Although the Small Business Administration is a political invention, the reason for its conception seems to be understandable, considering some of the deficiencies of our economy in meeting the demands of small business. During my interview in January of 1967, an officer of Continental Bank of Illinois's Small Loan Department agreed that this is particularly evident

if we consider that some bankers are apathetic and lack courage in the area of loans to small businesses.

Financial Assistance

In providing financial assistance to small business, SBA, in function, is like a bank. Banks can only supply loans. The SBIC program is the only one of the Small Business Administration's programs which is designed to make capital funds available to small business. That program has also turned out to be a loan program. Since Small Business Investment Companies have made only about one-eighth of their investments in the form of capital investments in small businesses, the supply of equity funds seems small when compared to the supply of loan funds.

The distinction between capital and loan funds is not simply academic; capital funds are vitally important to the survival of small businesses. This fact becomes of practical importance if we consider that, for instance, the Vice-President of Continental Bank of Illinois's Small Loan Department has found the lack of capital to be the foremost problem of small businesses.

Management Assistance

In providing management assistance, SBA's progress has been slow, as it is much more difficult to supply management knowledge than to supply dollars. Progress here will continue to be slow; but the Small Business Administration's efforts will be greatly aided by the "SCORE" program.

Procurement Assistance

The Small Business Administration has evidently had some resistance, especially from the Defense Department. Its joint set-aside program was not very effective. However, SBA's "certificates of competency" seem to be useful and worthwhile.

In the future, the whole area of procurement could undergo some changes, specifically in regards to the distribution of defense contracts among the states. As reported in Business Week, a recent study of Defense Department contracting indicated that

"subcontractors are even more concentrated in a handful of states than prime contractors."⁹⁴ While it is unlikely that SBA can do much to bring about any ^{THING} substantial itself, its programs could become more effective if more favorable policies regarding small business are adopted in the future by the Defense Department.

The SBIC Program

In its Small Business Investment Company program, SBA found itself in an unfortunate position. The accelerated growth in the field, relative to SBA's administrative resources, created severe administration difficulties and proved existing regulations to be inadequate. Consequently the Small Business Administration did not discover where its loans to the SBICs were invested and how they were used until some really serious problems became evident in the smaller, private companies and the resulting possible losses became substantial.

The program is now being reviewed and revised with the goal of strengthening the industry and eliminating the problems of the past. As the SBIC Administrator at Chicago's area office said during my interview with him, the program is being watched closely and "the new SBIC Administrator in Washington wants to personally approve all new dollar commitments to SBICs. In the future it will be harder to get money, and it will come in smaller amounts."

SBA's Future

Finally we can say that in the immediate future the Small Business Administration will continue to grow. It is still a relatively young agency with maturing functions and developing programs. Whether it will be a long-run success is speculation; but, for the meantime, small business and other interest groups are patiently continuing to give their support to SBA's efforts, as well as to other government and private organizations designed to insure the health and success of the small business segment of our economy.

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