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Congress of the United States

U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

October 4, 2012

Mr. Edsel Brown
Assistant Director
Office of Technology
United States Small Business Administration
409 3rd Street, S.W.
Washington, DC 20416

Re: Small Business Innovation Research Program (SBIR) Policy Directive; Final Rule, 77 Fed. Reg. 46,805 (Aug. 6, 2012); RIN3245-AF84; and Small Business Technology Transfer Program (STTR) Policy Directive; Final Rule, 77 Fed. Reg. 46,855 (Aug. 6, 2012); RIN 3245-AF45

Dear Mr. Brown:

On August 6, 2012, the Small Business Administration (SBA) published the aforementioned final rules to implement SBIR and STTR provisions contained in Title LI of the National Defense Authorization Act for Fiscal Year 2012, Pub. L. No. 112-81, 125 Stat. 1298, 1827 (2011) (NDAA). Adoption of the policy directive in final form[1] (with minor changes) will successfully update and modernize the SBIR and STTR programs.[2] More importantly, it will implement the intent of Congress.

I. Legislative Intent and Background for Rationale

The SBIR reauthorization legislation was designed to increase commercialization of SBIR-funded research, i.e., Phase III of the program. The legislation encouraged commercialization in three major respects.

Prior to the enactment of the NDAA, only those SBIR programs at the Department of Defense were authorized to conduct a formal commercialization effort in Phase III of the program. The NDAA extended that authority to all agencies required to operate a SBIR program.

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[1] Given the time deadlines set forth in the NDAA and the cycles of funding, the SBA was required to issue these directives as immediately effective upon publication in the Federal Register. The SBA requested comment on these directives and may well modify them based on such comments.

[2] Unless otherwise noted, the term SBIR shall refer to both the SBIR and STTR programs.

Second, the NDAA promotes greater participation from a wider array of small businesses by reducing the concentration of companies that receive Phase I and Phase II awards that do not move toward commercialization. Congress determined that the SBIR program had morphed into a contract research set-aside program exploited by a number of companies with expertise in writing grant proposals.[3] To counter this situation, Congress enacted § 5165 of the NDAA thereby imposing constraints on the ability of firms to receive SBIR funds from *any agency* if they have not achieved a certain level of commercialization success, i.e., moved to Phase III or a commercial equivalent thereof.

Finally, the NDAA permits companies that are majority-owned by qualifying venture capital, private equity and hedge funds to participate in the programs. Section 5107 of the NDAA statutorily overturns a 2003 determination by the Office of Hearings and Appeals of the SBA that dramatically limited the ability of small firms with investments from venture capital companies ineligible to participate in the SBIR program. Section 5107 eliminates the Hobson's choice that was imposed on small firms after the 2003 ruling – take funds from venture capital firms and lose the ability to participate in SBIR or lose important capital infusions and participate in SBIR. In short, § 5107 ensures that small businesses will have the maximum available capital to move on toward commercialization – a key goal of the original 1982 legislation.[4]

Given the language of the NDAA and the raisons d'etre behind the legislation, the directives generally implement the intent of Congress. The comments that follow assess the adequacy of the policy directives in implementing the NDAA. While the overall conclusion is that the SBA has done an excellent job of capturing the intent of Congress in the policy directives, there are instances where minor tweaks will ensure that the directives truly satisfy congressional intent.

II. Comments on Proposed Policy Directive

A. § 3—Definitions

SBA has adequately amended the definitions of "small business concern" by referencing its existing size standard regulations at 13 C.F.R. §§ 121.701-.705 and "commercialization" as required by § 5125 of the NDAA. Additionally, SBA has sufficiently amended the policy directive to include its definitions of "covered small business concern" to include entities that are majority-owned by venture capital operating companies. No changes are needed to these definitions to explain congressional intent.[5]

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[3] For example, the Committee on Small Business in the House found instances in which SBIR awardees received hundreds of Phase I and Phase II grants but little or no effort was made in the commercialization of such research.

[4] Despite what some views may be of the original progenitors of the SBIR program at the National Science Foundation in the late 1970s, the program instituted by Congress in 1982 made it clear that SBIR grants should, all else being equal in consideration of two grant applications, go to the applicant that secured additional private funding including funds from venture capital firms. Section 5107 simply returns the program to the intent of the original congressional authors of the program.

[5] Some industry groups may have certain technical concerns with these definitions. Nevertheless, those technical concerns, which should be addressed by the SBA, do not undermine the conclusion that the policy directives

B. § 4(3)—Competitively Phased Structure of the Program

The policy directive establishes clear guidelines for agencies to develop benchmarks that measure progress towards commercialization. As already noted, a primary rationale for enacting Title LI of the NDAA was to advance the commercialization of SBIR-funded research while limiting the ability of firms that obtain Phase I and Phase II awards from utilizing the program as a mechanism to obtain less than full and open competition federal contracts for research without ever intending to commercialize such research.[6]

For example, one company which testified before the Committee on Small Business in 2011 has received over 370 Phase I awards and over 185 Phase II awards for more than $162 million through its participation in the SBIR program. This is more than the SBIR dollars received since the inception of the program in 26 states, including Missouri, Montana, Delaware, Rhode Island, and Iowa. In fact, this company by itself has won more in SBIR funds than Idaho, Mississippi, Wyoming, and North Dakota combined. Yet, the company's rate of commercialization, from the available evidence, is minimal. While this may be the most hyperbolic example of transforming a commercialization program into a contract research program that benefits a limited number of small businesses, it is not the only company that shows undue concentration in SBIR funding awards that then reduces the likelihood that other innovative companies interested in commercialization are, due to the limited amount of funds available, excluded from the program. The NDAA, as already established previously in this comment letter, was designed to counteract this utilization of the SBIR funds as a tacit contract research set-aside program. Congress, with the enactment of § 5165, imposed constraints on the ability of firms to win an unlimited number of Phase I and Phase II awards without commercialization success.

The SBA directives do satisfy the intent of Congress when it enacted limits on participation without demonstrable success in commercializing SBIR-funded research. However, it is extremely important that the SBA continues to work with and approve agency success benchmarks that are clearly above de minimis levels. Without such vigilance both on the part of the SBA and in the agencies' development of commercialization success benchmarks, the efforts by Congress to constrain unbridled use of the SBIR program as a substitute for the normal federal procurement process will be for nought. This is one of the most significant changes in the NDAA; the SBA and covered agencies should treat it is as such, i.e., developing benchmarks marginally above de minimis levels will not satisfy the intent of Congress.

Additionally, the Committee on Small Business found instances where small firms in the SBIR program have experienced commercialization success directly from Phase I. The agencies

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implement the will of Congress. Any significant deviation from the approach set out in the policy directives would undermine the objectives sought by Congress when it enacted § 5107 of the NDAA.

[6] While there are some who believe that it is important for the government to determine whether a particular avenue of research is workable, mechanisms already exist by which the government can obtain that information – federal government contracts issued pursuant to Titles 10 and 41 of the United States Code. And small businesses are encouraged to participate in that contracting process as a result of the goals set forth in § 15 of the Small Business Act.

and the SBA must take the success of these exceptionally innovative firms into account when establishing the commercialization benchmark standards.

C. § 4 (b) Phase II Awards

The policy directive clearly establishes the option of companies to alternate between both the SBIR and STTR programs for the same project; a company may win a Phase I SBIR award and then go on to win a Phase II STTR award for the same project and vice versa. This is an unambiguous extrapolation from § 5104 of the NDAA expressing Congress' intent to allow such flexibility.

The SBA correctly interpreted this provision of the NDAA and via the policy directive, permits companies that are majority owned by multiple venture operating companies to participate in the STTR program. The SBA appropriately incorporated these changes into a single set of instructions. It would have been unnecessary and potentially confusing to participating companies and agencies for the SBA to establish two sets of guidance documents and size standard regulations for both the SBIR and STTR programs as it pertains to switching between both the SBIR and STTR programs.

Section 5106 of the NDAA provides that, for fiscal years 2012-2017, the National Institutes of Health, Department of Defense, and Department of Education may issue a Phase II award to a small business that did not receive an SBIR Phase I award. In certain instances, innovative small companies have already established the scientific and technical merit and feasibility traditionally accomplished in Phase I of the SBIR program. Should a company already demonstrate such technical feasibility and meet all of the qualifications traditionally done in Phase I, it is a logical postulation to make that the company ought to be eligible to apply directly for a Phase II with the goal of moving that product or process toward commercialization more expediently. Section 5106 does not remove the competitive nature of SBIR program and maintains the basic tenet that all companies must compete for awards. Finally, the provision does not create a preference or any other advantage for companies applying directly to Phase II.

As, yet again, previously indicated, the primary focus of the SBIR program is to commercialize research developed in the program. Allowing companies to apply for Phase II that have already competed such work traditionally done in Phase I allows them to move through the process more rapidly and commercialize their research sooner. As such, this section of the policy directive should remain unchanged as it sufficiently mirrors Congress' intent.[7]

D. § 4(c) Phase III Awards

The original intent of the Small Business Innovation Development Act (which established the SBIR program in 1982) was to increase government funding of small, innovative

[7] Others may object to this directive because it may reduce amounts available for Phase I grants (Phase II grants provide greater funds than Phase I). To those who object, that argument was lost when the President signed the NDAA. Attempting to have the SBA modify the directive would be akin to the agency legislating something the Constitution grants to Congress.

companies for the performance of research and development with commercial potential. Supporters of the SBIR program argued that while small companies were highly innovative, such firms traditionally were underrepresented in federal research and development activities.

To reinforce this basic premise, it is Congress' clear intention in § 5108 that, to the greatest extent practicable, Federal agencies and Federal prime contractors shall issue Phase III awards relating to technology (including sole source awards) to the SBIR award recipients that developed the technology. At times, agencies have neglected to use this authority and bypassed the small business that created the technology and pursued the Phase III work with another business. This is unacceptable. Participating agencies must make every effort to include the small businesses that developed the technology throughout the entire process. Should agencies not elect to utilize a sole source contract for a Phase III award, the agencies should be required to at the very least, give preference to the companies that developed the technology within the context of a full and open competition. The policy directive gives clear and precise guidance in this regard and sufficiently follows congressional intent.

These policy directives successfully mirror congressional objectives. As such, with the exception of the few modifications suggested above, the policy directive should be adopted in its current form. I appreciate your request for comments and thank you for your consideration.

Sincerely,

Sam Graves
Chairman
House Committee on Small Business

Cc: Mr. Sean Greene
Associate Administrator for Investment and Special Advisor for Innovation
Small Business Administration