



Testimony of

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“Under the Microscope: Reviewing the SBA’s Small Business
Size Standards”

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Chairman Williams, Ranking Member Velázquez, and Members of the Committee, thank you for the opportunity to testify before you today. My name is Brad Moore, and I am the CEO of Sterling Computers Corporation (“Sterling”), an Information Technology (IT) Value Added Reseller (“ITVAR”) that offers hardware, software, and technology services to the federal government, state and local governments, and education and commercial customers. Sterling has been family-owned and operated company since its founding; My cousin and his wife started the company in Torrance, California in 1996. Sterling has been headquartered in the Midwest for more than 20 years, and in the State of South Dakota for more than 10 years. Currently, we are headquartered in North Sioux City, South Dakota. Our modern, beautiful headquarters evokes the best of Silicon Valley and celebrates our South Dakota heritage. True to our commitment of giving back and investing in the local community, Sterling completely renovated 83,000 square feet of the old Gateway Computers headquarters—infamous for its enormous cow-spotted buildings—and cemented our roots to the Siouxland area, resulting in a merging of the past and the present, tradition and the future.

We committed to employing individuals from the local community. Sterling’s presence within the Siouxland community has resulted in a marked impact across the tri-state area. Economically, we support nearly 167 employees locally with payroll and competitive benefits, we host dozens of events throughout the year at local venues, and we leverage other community businesses as much as possible for our own internal needs.

Further, buoyed by our remarkable growth across all facets of our organization, Sterling has established Configuration, Integration, and Distribution (CID) centers in North Sioux City, South Dakota; Sacramento, California; and Dulles, Virginia. We also have offices established in Norfolk, Nebraska; Round Rock, Texas; Scottsdale, Arizona; and Cocoa Beach, Florida. All of whose aim is to meet the increasing demand for our unique brand of solutioning and procurement.

Sterling’s rise within the industry featured several key junctures, from our humble beginnings as a hardware reseller who primarily sold simple client deployments to commercial enterprises ... to a vast, nationwide organization specializing in hardware, software, cybersecurity, data center, and Cloud across all territories and verticals. We have provided products for missions to space, for technology used to advance medical science, and to provide for distributed citizen services. Sterling is continuing to grow and mature as a leading AI integrator today. We create digital humans and are working with the most prestigious academic institutions to advance 5G/6G technology – all from a rural community. We continue to leverage our Midwestern values, chase after lofty goals, and pursue excellence in all things, as we support our customers with character and tenacity.

At the core of Sterling’s capabilities is “Transformation.” This is not just about changing from one state to another; it’s about uniquely combining our strengths, resources, and competencies to create a distinct outcome for our customers. Over the years, we have experienced unprecedented growth, causing us to primarily size out of the Small Business Administration’s (“SBA”) “small business” size determination. While we are grateful for our success, Sterling now faces unique challenges as a midsize business that must now compete against large corporations. In my testimony today I will outline some of the challenges we have

experienced in the federal market as a small business, as well those that continue in our transition to the full and open marketplace.

As an ITVAR, our role in the IT Channel is to offer our customers a reliable, nimble, secure and competent partner in their quest for excellence through modern technology, often acting as an intermediary between government agencies and the creators of this technology who are often referred to as OEMs or Original Equipment Manufacturers. Our company sized out of small business status under NAICS code 541519 in 2019 as we crossed over the 150 employee threshold. Our employee growth has been caused by two primary factors. First, our business success. We are a leading supplier on several government GWACS, such as SEWP, CIO-CS and 2GIT, and we are a valued supplier to many of the large government system integrators. We are also a valued partner to the largest OEMs in our industry, such as Dell, Cisco, HPE, Oracle, and Microsoft, and have high levels of partnership with our OEM partners. Second, the increased demand for capabilities by both our government customers and the large government system integrators, and our OEM Partners. With our business success and the increased demand for capabilities, has come an increase in the compliance burdens placed upon us. We have hired specialized employees in order to effectively manage our growing slate of compliance obligations. Today, Sterling employs 35 individuals who are dedicated solely to compliance and management of the complex demands of federal contract procurement and the regulatory landscape. Moreover, the 130 other individuals who comprise our technical and engineering teams—holding, collectively, over 460 advanced industry certifications, the possession of which is a requirement of conducting business with our OEM partners—and it quickly becomes evident why we crossed over the 150 employee threshold.

Sterling understands the Federal Government depends on small businesses to round out its supply chain and to facilitate achievement of important procurement goals. Each year, Congress sets Federal small business procurement goals in order to ensure “small businesses have the maximum practical opportunity to participate in providing goods and services to the Federal Government.”¹ Currently, the Governmentwide goal for participation by small business concerns is “not less than 23 percent of the total value of all prime contract awards for each fiscal year.”² In 2022, the Federal Government exceeded its 23% goal for the tenth consecutive year³;

¹ U.S. SMALL BUSINESS ADMINISTRATION, FY 2023 Goaling Guidelines, 2 (Dec 2022), *available at* https://www.sba.gov/sites/default/files/2023-01/FY23%20Small%20Business%20Goaling%20Guidelines_Final_221130%20%281%29.pdf; *See* Small Business Act of 1958 § 2(a), 15 U.S.C. § 631.

² 15 U.S.C. § 644(g)(1)(A)(i). Once the annual Governmentwide goals are set, the Small Business Administration (“SBA”) works with each agency to set an agency-specific goal for small business prime contracting and subcontracting. U.S. SMALL BUSINESS ADMINISTRATION, FY 2023 Goaling Guidelines, 3-6 (Dec 2022), *available at* https://www.sba.gov/sites/default/files/2023-01/FY23%20Small%20Business%20Goaling%20Guidelines_Final_221130%20%281%29.pdf The agency-specific small business goals for fiscal year 2024 range from 13.75 percent to 70 percent. U.S. SMALL BUSINESS ADMINISTRATION, FY 2024 Small Business Goals, 1 (Jan 2024), *available at* https://www.sba.gov/sites/default/files/2024-01/FY24_Final_Goals_508.pdf

³ *See* U.S. Small Business Administration: Small business procurement scorecard overview (last visited Feb 1, 2024), *available at* <https://www.sba.gov/document/support-small-business-procurement-scorecard-overview>

awarding \$162.9 billion in federal procurement opportunities (or 26.5% of total federal contract dollars) to small businesses, an \$8.7 billion increase from the previous fiscal year.⁴

Twenty years ago—when the SBA first established the industry category and size standard of 150 employees for those ITVARs who fell under NAICS code 541519—the IT landscape was vastly different than it is today. Our industry has, of course, evolved—some might say exploded—in the years since. As the focus of government spending shifts more and more towards innovation and meeting agencies’ burgeoning technology needs, small businesses are providing the Government with information technology more than ever before, including hardware, software, and cloud computing. In many cases, these small businesses are ITVARs that provide beneficial value-added services. These small business ITVARs can provide efficient and cost effective solutions for complex IT procurements, in addition to helping the Government meet its small business goals and creating more competition in the market. Thus, small business ITVARs are critically important to federal government procurement.

Yet, alongside the evolution of the IT landscape has come an increase in the breadth and complexity of the compliance burdens placed upon ITVARs. The current regulatory landscape includes a patchwork of rules and regulations for small businesses, including rules specific to the IT industry, that are unworkable in many cases. Issues and restrictions surrounding small business procurements have led to frequent misclassification of IT procurements and potential liability for contractors. This, coupled with contractor misunderstanding of the rules and a seeming unwillingness by agencies to correct issues or grant necessary waivers, has made it challenging – and in many cases impossible – for small business ITVARs to participate in federal procurements without potentially violating the law. In many instances, small business ITVARs are forced to choose between missing out on federal business opportunities and potentially opening themselves to considerable liability. To both mitigate this considerable liability and continue to compete for federal business opportunities, ITVARs look to hire employees to manage their growing slate of compliance obligations. However, this increased headcount presents a new dilemma for small business ITVARs, as they are forced to choose between increasing their headcount to effectively navigating the complex demands of federal contract procurement by increasing their headcount, and foregoing hiring those employees to stay below the 150 employee threshold and maintain its status as a small business. As the IT industry evolves and the government’s demands for IT solutions increases, so too should the rules applicable to IT procurements, particularly where this will allow more opportunity for small businesses to compete.

I. Benefits of the Small Business IT Value-Added Reseller in Federal Contracting

Due to changes in how the Federal Government uses and procures IT, the type of small business providing IT to the Government has changed considerably, resulting in a new category of small business – the small business ITVAR. The small business ITVAR has been able to fill an important role where, generally, the Government (1) prefers to obtain IT equipment and supporting services from a single source; (2) regularly uses a single acquisition to obtain

⁴ U.S. SMALL BUSINESS ADMINISTRATION, *Biden-Harris Administration Sets Record-Breaking \$163 Billion in Federal Procurement Opportunities to Small Businesses*, (July 18, 2023), available at <https://www.sba.gov/article/2023/07/18/biden-harris-administration-sets-record-breaking-163-billion-federal-procurement-opportunities-small>.

numerous IT products that typically are not produced by any one original manufacturer; and (3) requires the contractor to customize computer hardware or software to meet an agency’s specific needs.⁵ ITVARs purchase IT products from the original manufacturer (or from another distributor) and resell the products to end users.⁶

But, rather than acting solely as an intermediary, many ITVARs provide valuable, customized IT solutions including configuration consulting, systems integration, and installation of multi-vendor computer equipment. Many of these services are provided pre-award, and thus are not directly reflected in eventual contract award amounts. Specifically, ITVARs provide access to engineers and architects with subject matter expertise that assist the Government in creating and implementing customized, scalable solutions. They serve to strategically connect Government with original equipment manufacturers (OEMs) in innovative ways. Further, many ITVARs provide pre-contract services to include access to demonstration centers, which allows the Government customer to conduct proof of concept testing to ensure the proposed solutions and equipment work as expected prior to making a final purchasing decision. To ensure the highest levels of competency, ITVAR employees may maintain multi-vendor certifications that indicate employees have the necessary skills to implement and operate key products. In addition, due to their industry position and structure, ITVARs can ensure that Government-required cybersecurity and supply chain risk management standards are in place to safeguard Government data and systems. These critical services are provided with minimal, if any, added cost to the government because they are included in overhead costs, covered by narrow margins on the IT products, and generally not separately charged. As such, ITVARs exist as a trusted and cost-effective conduit for original manufacturers to reach Government customers, and they pass these savings along to the Government.

Small business ITVARs are an integral part of the federal government pipeline. Nevertheless, a patchwork of rules and regulations specific to small businesses and the IT industry specifically have made it challenging, and in some cases impossible, for small business ITVARs to participate without potentially violating the law.

II. The Current Landscape of Small Business Procurement Requirements

A. North American Industry Classification System (“NAICS”) Codes

The North American Industry Classification System (“NAICS”) is the standard hierarchical classification system used by the Federal Government to classify business establishments into specific industries.⁷ Although the NAICS Codes in many cases do not entirely mirror their specific requirements, agencies have adopted NAICS codes for – and these codes have a substantial impact on – federal procurements.

⁵ See Small Business Size Standards: Industries With Employee Based Size Standards Not Part of Manufacturing, Wholesale Trade, or Retail Trade, 81 Fed. Reg. 4436, 4443 (Jan. 26, 2016), *available at* <https://www.govinfo.gov/content/pkg/FR-2016-01-26/pdf/2016-00922.pdf>.

⁶ Anne Pilon, *How to Become an IT Reseller*, SMALL BUSINESS TRENDS (Sept. 11, 2018), *available at* <https://smallbiztrends.com/2018/09/it-reseller.html#:~:text=An%20IT%20reseller%20is%20a,intermediary%20in%20the%20distribution%20process.>

⁷ U.S. Census, North American Industry Classification System: Introduction to NAICS, *available at* <https://www.census.gov/naics/> (last visited Feb 1, 2024).

In federal contracting, NAICS codes have two primary purposes: (1) to identify the purpose of the procurement, and (2) to identify the size standard an entity must meet to qualify as a small business for that procurement. When issuing solicitations, contracting officers are required to designate a single NAICS code that “best describes” the principal purpose of the product or service being acquired.⁸ Often, a procurement for IT-related acquisitions may be a mixed procurement, involving both products and services. For these mixed procurements, the contracting officer still must assign a single NAICS code according to the “component which accounts for the greatest percentage of contract value.”⁹ This causes problems for ITVARs because in many cases these entities provide a combination of products and services not contemplated by traditional NAICS codes, and offer new technology, *i.e.*, software and/or cloud, that reasonably can be classified as a product or a service.

In addition to assigning codes to communicate the purpose of a procurement, the Government also uses NAICS codes “to establish size standards governing which entities qualify as small businesses for preferences or eligibility under government programs and procurements.”¹⁰ Generally, the size standards for supplies (under the “Supply Codes”)¹¹ are defined in terms of number of employees, and the size standards for services (under the “Service Codes”)¹² are defined in terms of average annual receipts. Although there are exceptions (some of which apply to ITVARs), “[m]ost manufacturing companies with 500 employees or fewer, and most non-manufacturing businesses with average annual receipts under \$7.5 million, will qualify as a small business.”¹³ As such, these NAICS code designations largely depend on the nature of the items being acquired – for example, whether those items are supplies or services – and dictate the competitive pool of potential offerors.

The existing traditional NAICS codes used for federal contracting, and the corresponding SBA size standards, generally are not appropriate for small business ITVARs. Establishments that are “primarily engaged in” providing services can properly be classified under a Service Code.¹⁴ Small business ITVARs provide hardware, software, and related products (supplies) that are manufactured by other companies along with services related to those products. Thus, the primary focus of the offerings available from ITVARs are not services and ITVARs generally cannot properly be classified under the Service Codes. Likewise, the Supply Codes used for federal procurements cover establishments that *manufacture* each specific product. Since the

⁸ 13 C.F.R. § 121.402(b).

⁹ 13 C.F.R. § 121.402(b)(2).

¹⁰ *Rotech Healthcare, Inc. v. United States*, 71 Fed. Cl. 393, 407 (2006).

¹¹ Service Codes begin with “5,” for example, 518210 – Computing Infrastructure Providers, Data Processing, Web Hosting, and Related Services.

¹² Supply Codes begin with “3,” for example, 334111 – Electronic Computer Manufacturing.

¹³ U.S. SMALL BUSINESS ADMINISTRATION, *Basic Requirements: Meet Size Standards*, available at <https://www.sba.gov/federal-contracting/contracting-guide/basic-requirements> (last visited Feb 1, 2024).

¹⁴ Each NAICS code description begins with “This industry comprises establishments primarily engaged in” See, e.g., NAICS Association, NAICS Code Description for 334111 – Electronic Computer Manufacturing, available at <https://www.naics.com/naics-code-description/?code=334111> (Last visited Feb 1, 2024).

products ITVARs provide often are manufactured by other companies, small business ITVARs do not fit neatly under the NAICS Supply Codes either.¹⁵

Relatedly, the existing SBA size standards associated with the NAICS product and service codes are not appropriate for small business ITVARs. The current employee-based size standards do not capture the fact that to be an ITVAR in the government sector is an employee-heavy burden. As mentioned previously, numerous employees are needed for compliance and ITVARs must obtain a wider breadth of knowledge with multiple OEMs than an IT service company would. Those numbers do not yet reflect the staff required to sell, purchase, track, invoice and collect during the course of business. Small businesses are not exempt from these requirements from the government nor the OEMs. To stay under the 150 employee small business size standard of 541519, small businesses must sacrifice hiring at the expense of obtaining and maintaining government mandated certifications and capabilities, or forgo obtaining advanced certifications with the OEMs, which hurts the portfolio of products they are able to offer and also negatively affects their pricing discounts and profitability.

There is a current trend of consolidation and acquisitions in our industry. It is common for VARs, once they exceed 150 employees, to sell their businesses. These VARs, who usually have years of experience in government contracting and mature capabilities, are purchased by larger industry competitors or private equity firms. There has been a mass exodus of firms from the industry once the size standard is exceeded. This hurts the federal government as they lose small businesses and qualified suppliers who are often replaced with less qualified and less capable suppliers. The unicorn in the ITVAR industry has become those companies with between 151 and 500 employees. To go from successfully competing as a small business to competing with companies like CDW (who has 15,000 employees) and IBM, once you reach 151 employees, is an improbable endeavor. The result is an erosion of the supplier base that has valuably serviced the government at the moment when they reach economies of scale. Not only does the government suffer under this scenario, but so do the employees and the communities where these businesses are located as the acquiring companies or private equity firms are headquartered in larger metropolitan areas. Increasing the employee size limit to 500 employees would insure there are ample small businesses that are qualified to meet the higher demands of today's government customers and would stay within the SBA PPP loan program guidelines used during the Covid Pandemic.

Moreover, the size standards based on revenue do not capture the fact that ITVARs typically operate on low margins. Consequently, their annual receipts can quickly surpass the size standard dollar thresholds. Thus, the typical size standards for Service Codes (\$7.5 million in revenue) are too low for the ITVAR industry. This often results in excluding competent and

¹⁵ Many small business ITVARs could be appropriately categorized under the Wholesale Trade NAICS codes (e.g., 423430 – Computer and Computer Peripheral Equipment and Software Merchant Wholesalers). However, SBA regulations explicitly prohibit the government from classifying acquisitions for supplies under Wholesale Codes. See *NAICS Appeal of Global Precision Systems, LLC*, SBA No. NAICS-5681 (2015) (explaining 13 C.F.R. § 121.402(b)(2) requires that “[a]cquisitions for supplies must be classified under the appropriate manufacturing or supply NAICS code, not under a Wholesale Trade or Retail Trade NAICS code.” Thus, even though the solicitation called for the contractor to distribute items manufactured by others, because the “heart of the procurement” is for supplies, it must be categorized under a manufacturing or supply code.); see also <https://smallgovcon.com/naics-code-appeals/no-wholesaler-naics-codes-for-set-aside-contracts-sba-oha-confirms/>

successful ITVARs that would otherwise qualify as small businesses (based on employee headcount).

In sum, traditional NAICS Supply Codes and Service Codes, and existing size standards, are not appropriate classifications for small business ITVARs, and, as discussed more fully below, present unique problems in the federal procurement context.

B. Unique Challenges for Small Businesses

Twenty years ago, when the SBA established the industry category and size standard of 150 employees for ITVARs using 541519, the landscape was vastly different than today. Our industry has evolved and exploded over even the last five years. The burden placed on ITVARs has increased drastically as well. With an increased focus on secure supply chain, certification requirements such as ISO certifications, CMMC, Supply Chain Risk Management, Environmental, ITAR, security clearances, Affirmative Action and others, ITVARs must now hire employees to manage compliance.

Today, Sterling employs 35 individuals who are dedicated to government program management and compliance. This includes contract program managers, deputy program managers, and a legal and compliance group that is responsible for the many certification requirements mentioned previously. Our OEM partners, who we team with to provide products to our government customers, also require us to hold increasingly advanced certifications to be authorized to sell their products. Currently, we have 130 unique individuals with 460 industry certifications. These certifications and OEM relationships are necessary to perform on our contracts, providing the necessary expertise required as the “value-add” in our industry. Government customers are also requesting these advanced OEM certifications as a requirement to bid on certain procurements. As an example, many requests for CISCO products now require the bidder to be a CISCO GOLD certified partner. Sterling has that certification; however, it was a timely and costly endeavor.

It is often difficult for small businesses to navigate these issues (and it has become apparent that many small businesses do not understand these issues), particularly where the Government has set-aside a procurement based on an inappropriate NAICS code. Currently, a \$25 billion dollar industry is classified as an exception to a NAICS code that does not truly reflect what that industry does. ITVARs are lumped in the same code as IT service companies but are not the same. The types of services offered by each can be dramatically different as can the number of employees needed to support their businesses.

1. Limitation on Subcontracting Rule

For supplies and services, the limitation on subcontracting rule (“LOS”) requires that a small business not subcontract more than 50% of the prime contract amount to businesses that are not “similarly situated.”¹⁶ In contracts for mixed procurements (i.e., both supplies and services), “the limitations on subcontracting apply only to subcontracts that correspond to the

¹⁶ 13 C.F.R. § 125.6; FAR 52.219-14. Under 13 C.F.R. § 125.1, a “similarly situated entity means a subcontractor that has the same small business program status as the prime contractor.”

principal purpose of the prime contract.”¹⁷ The LOSR is problematic for small business ITVARs that resell IT products (e.g., hardware, computers, etc.) and/or services (e.g., cloud, hardware/software maintenance, etc.) to an end-user that originate from other companies. Often, the products and services the Government requires under the solicitation are provided only by large companies, and easily exceed 50% of the total contract amount. Thus, when applied, the LOSR has the effect of eliminating small business ITVAR participation in many federal acquisitions for IT products and services although they are set-aside for small businesses.

2. The Non-Manufacturer Rule

Specific to supply contracts, the non-manufacturer rule (“NMR”) allows a small business to supply products it did not manufacture to the Government as long as certain requirements are met, including that the supplied products were manufactured by another small business.¹⁸ A business generally may qualify as small under the NMR where it has 500 or fewer employees.¹⁹ Small businesses may supply products manufactured by *any size* business if the SBA grants a waiver of the NMR.²⁰ There are two types of waivers: (1) an “individual” waiver, requested by the contracting officer and approved by the SBA, for a specific contract when there is no small business manufacturer that can meet the contract’s requirements; and (2) a “class” waiver if there are no small business manufacturers available to supply a class of products.²¹

While class waivers exist for some hardware, currently, there are no class waivers for software products.²² Thus, a small business ITVAR cannot participate in opportunities involving the purchase of commercial software manufactured by large businesses such as Microsoft, Oracle, Adobe, and Citrix, even where the Governmental agency specifically requires such software. Rather, small businesses can participate in such opportunities only when the contracting officer exercises his or her discretion and requests an individual waiver. Notably, it is not mandatory for the contracting officer to request an individual waiver, and it seems in most cases the contracting officer will choose not to seek a waiver, even if the acquisition is set up as a small business set-aside for product for which there is no small business manufacturer. This practice flies in the face of established rules and sets up unwary contractors to violate the NMR

¹⁷ Small Business Government Contracting and National Defense Authorization Act of 2013 Amendments, 81 Fed. Reg. 34243, 34245 (effective June 30, 2016), *available at* <https://www.govinfo.gov/app/details/FR-2016-05-31/2016-12494>

¹⁸ 13 C.F.R. § 121.406 (b).

¹⁹ 13 C.F.R. § 121.406 (b)(1)(i). To qualify under the Information Technology Value Added Reseller exception to NAICS Code 541519 (Footnote 18), a business must not exceed 150 employees. *See* Section IV.A below.

²⁰ 13 C.F.R. § 121.406 (b)(5)-(7).

²¹ *Id.*

²² For example, the NMR Class Waiver list provides a very limited waiver for 334111 Mainframe Computers and Peripherals (note, peripherals are covered only when purchasing a mainframe computer), a waiver for 334111 commercially available off-the-shelf laptop and tablet computers, and a waiver for 334118 Printers, Computer, Manufacturing. *See* the NMR Class Waiver List at p. 12, *available at* <https://www.sba.gov/sites/default/files/2022-10/NMR%20Class%20Waiver%20List%20-%20version%20June%202022.pdf>.

(and, potentially, the False Claims Act) simply for following the requirements set forth by the Government.²³

III. Various Attempts to Modify the Rules for Information Technology Procurements

Recognizing the traditional rules and regulations cannot properly be applied to ITVARs, the SBA and agencies have sought numerous workarounds. Indeed, various workarounds have been utilized by the SBA and government agencies because the rules have not adapted to quickly changing technology-related procurements. Ultimately, this piecemeal approach has failed. As a result, at least one government agency now is attempting to circumvent the onerous requirements by acquiring a blanket waiver.²⁴ This clearly demonstrates the need for a more complete solution, specifically tailored to meet the unique requirements of the Government and enable contractors to provide the best possible solutions with respect to IT procurements.

A. ITVAR Code 541519 (Footnote 18)

The SBA created a new sub-industry category for Information Technology Value Added Resellers (“ITVARs”) under NAICS code 541519, with a corresponding size standard of 150 employees.²⁵ To accomplish this, it amended 13 C.F.R. § 121.201 by adding a footnote (Footnote 18), which provides a definition of ITVAR and describes the circumstances under which a procurement could properly be classified under the industry code 541519. The stated purpose of establishing this industry category was to “better apply small business eligibility requirements under Federal contracts that combine substantial services with the acquisition of computer hardware and software.”²⁶ SBA believed establishing the ITVAR industry category was a “more effective approach to addressing the size eligibility requirements of nonmanufacturers providing substantial services along with IT products.”²⁷

Specifically, Footnote 18 requires an ITVAR classified under 541519 to “provid[e] multi-vendor hardware and software along with significant value added services. Significant value added services consist of, but are not limited to, configuration consulting and design, systems integration, installation of multi-vendor computer equipment, customization of hardware or

²³ Small businesses also are subject to affiliation rules. For example, the ostensible subcontractor rule treats a prime contractor and its subcontractor “as joint ventures, and therefore affiliates, for size determination purposes” when the subcontractor “performs primary and vital requirements of a contract,” or the prime contractor is “unusually reliant” upon the subcontractor. 13 C.F.R. § 121.103(h)(3). *See Size Appeal of Red River Computer Co., Inc.*, SBA No. SIZ-5512 (2013) (affirming that Red River was not a small business for a procurement involving Cisco’s hardware and software maintenance where Cisco would perform most of the work because Red River was affiliated with Cisco under the ostensible subcontractor rule).

²⁴ The SBA approved a waiver to the NMR for the First Source III program and all delivery orders issued under FirstSourceIII. The NMR waiver was sought by DHS and approved by SBA on September 15, 2020 and applies to the NAICS codes under FirstSource III. *See* FirstSource III information at https://beta.sam.gov/opp/1d1105e4b3c440f5822ce86892fb5db1/view_

²⁵ Small Business Size Standards; Information Technology Value Added Reseller, 68 Fed. Reg. 74833 (Dec. 29, 2003), *available at* <https://www.govinfo.gov/app/details/FR-2003-12-29/03-31795>.

²⁶ *Id.*

²⁷ *Id.* At 74841.

software, training, product technical support, maintenance, and end user support.”²⁸ As set forth in the regulation, the percent of value added services under Footnote 18 is measured as follows:

For purposes of Government procurement, an information technology procurement classified under this exception and 150-employee size standard must consist of at least 15% and not more than 50% of value added services, as measured by the total contract price.

13 C.F.R. § 121.201 n. 18. (emphasis added). Thus, to qualify, a small business ITVAR must provide and charge the Government for value added services equivalent to between 15% and 50% of the total contract price. As discussed above, much of the value-added services provided by ITVARs occur prior to contract award and/or are built into existing pricing and not separately charged. Under the current Rule, measuring the percent of value added services as compared to the total contract price, the 15-50% requirement is unrealistic and will serve to unnecessarily increase the costs to the Government of meeting its small business goals.

Indeed, ITVARs add significant value to IT hardware and software products, in the form of features and services, prior to reselling those products to end-users. For example, ITVARs might provide configuration consulting, systems integration, and installation of multi-vendor computer equipment. These services are incredibly valuable to the government end-user, particularly where the Government often exhibits a preference to obtain IT equipment and supporting services from a single source. However, ITVARs generally do not charge separately for these value-added services. Rather, the service costs are incorporated into the company’s overhead costs. As such, the services often do not account for 15% of the total contract price.

Under Footnote 18, an ITVAR contractor must comply with the NMR.²⁹ This is a change to the regulation made in 2016; prior to this, an ITVAR contractor was not subject to the NMR.³⁰ As discussed in more detail in Section III.B.2., above, applying the NMR to procurements of IT products presents several challenges for small business ITVARs and in many cases is inconsistent with what agencies specifically require in their solicitations. The ITVAR exception under NAICS code 541519 is insufficient to categorize the products and services required in recent complex agency IT procurements.

B. Software Code 513210 (Footnote 15)

Shortly after the current version of the ITVAR Footnote 18 was instituted in 2016, a separate SBA Rule went into effect amending certain SBA regulations related to software.³¹ The new Rule relates to the current NAICS code 513210, Software Publishers, a services code with a

²⁸ 13 C.F.R. § 121.201 n. 18.

²⁹ 13 C.F.R. § 121.201 n. 18 (“The offeror must comply with the manufacturing performance requirements, or comply with the non-manufacturer rule by supplying the products of small business concerns, unless SBA has issued a class or contract specific waiver of the non-manufacturer rule.”).

³⁰ Small Business Size Standards: Industries With Employee Based Size Standards Not Part of Manufacturing, Wholesale Trade, or Retail Trade, 81 Fed. Reg. 4436, 4441 (Jan. 26 2016), *available at* <https://www.govinfo.gov/app/details/FR-2016-01-26/2016-00922>.

³¹ Small Business Government Contracting and National Defense Authorization Act of 2013 Amendments, 81 Fed. Reg. 34243 (May 31, 2016), *available at* <https://www.govinfo.gov/app/details/FR-2016-05-31/2016-12494>.

size standard of \$47M. Relevant to ITVARs, the Rule classified unmodified, commercially available software supplied in procurements governed by NAICS code 513210 (“Software Publishers”) as an item of supply rather than a service, thus subjecting these items to the nonmanufacturer rule.³² To accomplish this, the SBA amended 13 C.F.R. § 121.201 by adding a footnote (Footnote 15), which explains that NAICS code 513210 is the proper NAICS code to use when the Government is purchasing commercially available off-the-shelf (“COTS”) software, which is eligible for a waiver of the nonmanufacturer rule. Specifically, Footnote 15 reads:

NAICS code 513210 – For purposes of Government procurement, the purchase of software subject to potential waiver of the nonmanufacturer rule pursuant to 121.1203(d) should be classified under this NAICS code.

13 C.F.R. § 121.201 n.15. Characterization of COTS software as a product subject to the nonmanufacturer rule presents the added complication of seemingly conflicting size standards applicable to these procurements. The NAICS code 513210, a services code, has a size standard of \$47M, while a company may qualify as small under the nonmanufacturer rule based on a size standard of 500 employees.³³ Clarity has yet to be provided by the SBA on this issue.

As noted above, one intended consequence of changing the classification for COTS software to a supply was that the NMR then became applicable to procurements for this type of software, and waivers then could be sought. The Rule amended the SBA regulations to include a specific subsection regarding “waivers for the purchase of software.”³⁴ Section 121.1203(g) says the “SBA may grant an individual waiver for the procurement of software,” provided the software meets certain conditions.³⁵ Individual waivers may be requested by contracting officers and the public can request that SBA issue class waivers for software items.³⁶ However, in practice contracting officers have been reluctant to request a contract specific waiver prior to issuing the solicitation, and, to date, no class waivers for software have been granted.³⁷

A class waiver here would be appropriate and a large step in the right direction for resolving many of the issues facing small business resellers. Specifically, four aspects of this new sub-industry strongly favor a class waiver specifically for the Footnote 15 portion of NAICS 513210: (1) the COTS software purchased under this NAICS Code is so overwhelmingly manufactured solely by large businesses that it obviates the purpose of the NMR; (2) the small business set-asides utilized under this code are almost universally in violation of the NMR;

³² The rule does not apply to *customized* software, which would remain classified as a service. *See id.* at 34255 (“Clearly, when the Government seeks to award a contract to a business concern to create, design, customize or modify custom software, that should be classified as a service requirement and the activity will remain classified in a service NAICS code to which the nonmanufacturer rule does not apply. For a service procurement set aside for small business, the prime (together with one or more similarly situated subcontractors) would have to perform the required percentage of work.”).

³³ 13 C.F.R. § 121.201; § 121.406(b).

³⁴ *See* § 121.1203(g).

³⁵ *Id.*

³⁶ 13 CFR 121.1204.

³⁷ *See* the NMR Class Waiver List, available at <https://www.sba.gov/sites/default/files/2022-10/NMR%20Class%20Waiver%20List%20-%20version%20June%202022.pdf>.

(3) these violations are almost forced by the Government’s dual need for both large business software and small business credit, leading to improper solicitations; and (4) this situation invites small businesses to expose themselves to the potentially existential risk of misrepresenting their size status.

C. Cloud Computing

The SBA issued a rule effective December 30, 2019 to lift restrictions for small businesses seeking to provide the Government with cloud computing solutions.³⁸ This rule acknowledges the reality that, in most instances, a small businesses is not able to commit to a procurement in which it (together with other small businesses, if needed) will provide more than 50% of the services under a contract involving cloud computing, where the cloud computing market is dominated by large companies. To allow more small business participation in opportunities involving cloud computing, the SBA reiterated its position that cloud computing is a *service*, and it may be excluded from the LOSR calculation where a small business will perform other services that are the primary purpose of the acquisition.³⁹ Here, the SBA created a specific, workable rule for cloud computing by recognizing and accounting for the unique aspects of the cloud computing market.

D. Blanket Waivers

A separate work-around involves obtaining waivers. As mentioned above, one way to allow small businesses to supply software manufactured by large corporations is to secure an individual waiver issued for a vehicle that covers a full array of IT orders of a government department. The Department of Homeland Security (“DHS”) is currently working on a solicitation for a multiple-award contract known as FirstSource III and sought an individual waiver for all of the products and services to be procured under the contract, which was approved by the SBA on September 15, 2020.⁴⁰

Under FirstSource III, any commercial IT product would be available, including products manufactured by large companies. Notably, FirstSource III will have two NAICS codes, 541519 (ITVAR) and 513210 (software publishing). To resolve the NMR issues, DHS is pursuing an individual contract level NMR waiver for FirstSource III. If the SBA approves the wavier, there would be no need for individual waivers for each order under FirstSource III.

DHS’s attempt to secure a blanket waiver for the First Source III contract signals the Government’s recognition of the need to change the rules to adapt to the evolving information technology landscape. A broader change is warranted for other types of IT procurements, particularly for those involving small business ITVARs.

³⁸ 13 C.F.R. 125.6; 84 FR 65647 at 65664.

³⁹ Notably, in its proposed rule, the SBA considered recharacterizing cloud as a “product” (rather than a “service”), which would bring the NMR into play and allow SBA to issue broad waivers of the rule, 83 Fed. Reg. 62516. This proposed solution is the same as that adopted for commercial software (described above), Seemingly, the SBA realized the approach for software was not working and decided to go a different route to facilitate small business participation in procurements involving the cloud.

⁴⁰ See the FirstSource III information at https://beta.sam.gov/opp/1d1105e4b3c440f5822ce86892fb5db1/view_

IV. Potential Liability for Small Businesses Under the Current System

The Government regularly issues solicitations under inappropriate NAICS codes, thereby inviting small business contractors to violate the Small Business Act and exposing those small business contractors to risk of fines, debarment, or other penalties. Many times, small businesses do not fully understand the complicated rules, and there is little compliance oversight by the Government with respect to NAICS codes. Rather, the onus has shifted to small businesses to use already scarce time and resources to police government agencies via protests. Relying on protests to check this frequent misuse is unrealistic, costly, and unfair for small businesses.

For example, the Government regularly posts solicitations for acquisitions of COTS software manufactured by large businesses that are classified under NAICS 513210 and set-aside for small businesses and, overwhelmingly, the software the Government purchases under 513210 is manufactured by large businesses.⁴¹ As discussed above in Section III.B.2, the NMR applies to these solicitations unless the contracting officer has obtained a waiver from the SBA.⁴² If a waiver is granted, the solicitation can be set-aside for small businesses, and the small business awardee can provide an end-product made by any size manufacturer. In practice, waivers are rarely obtained.⁴³ If the solicitations do not include a waiver of the NMR, any small business awardee must provide an end-product made by a small business manufacturer. As discussed above in Section III.B.2, in many instances, this is not possible because the Government often specifically requests items manufactured exclusively by large businesses, or because certain products are not manufactured by small businesses. Without a waiver, any small business awardee that provides the required COTS software (manufactured by a large business) under a set-aside is violating the Small Business Act, opening itself to liability under the False Claims Act for making false statements and certifications to the Government, and subjecting itself to a host of other negative consequences – all at the behest of the Government agency.

Another issue facing small businesses in the IT space is agency misapplication of the ITVAR Code by assigning 541519 to solicitations when it is not appropriate; for example, when the contract necessarily includes services that account for less than 15% of the total contract price. In this situation, small businesses that otherwise meet the value-added requirements are stuck between a rock and a hard place. They can choose to bid, knowing they will not provide services that account for 15-50% of the total contract price as required by 541519, and thus potentially setting themselves up for an allegation that they have violated the law or made a false certification. Or, the small business can forgo the opportunity altogether, while less risk-averse competitors are awarded the work.

⁴¹ As of May 2019, a review of FedBizOps revealed more than 40 small business set-asides under 513210 (at that time, classified as NAICS code 511210) for COTS items. Nearly 70% of the solicitations specifically requested COTS items manufactured by large businesses and did not include a waiver of the NMR.

⁴² Alternatively, the contractor (rather than the government) can seek a class waiver for classes of products where no small business manufacturers of those items exist. However, the SBA seems reluctant to issue such waivers. While certain hardware has been subject to a waiver, no class waivers for software currently exist. *See* the NMR Class Waiver List, available at <https://www.sba.gov/sites/default/files/2022-10/NMR%20Class%20Waiver%20List%20-%20version%20June%202022.pdf>.

⁴³ *See* Note 43, above.

This happens because IT service companies offer project management, architecture, maintenance of systems, operations, and monitoring that many times are on-site at the customer location for long periods of time. These services are almost always billed to the customer and have a small portion of gross profit tied to product sales.

The services offered by ITVARs more often revolve around configuration consulting, pre-purchase architecture, compatibility, functionality, delivery and integration of systems. Indeed, ITVARs add significant value to products, in the form of features and services, prior to reselling those products to end-users. These services are incredibly valuable to the government end-user, particularly where the Government often exhibits a preference to obtain IT equipment and supporting services from a single source. However, ITVARs generally do not charge separately for these value-added services. Rather, the service costs are incorporated into the company's overhead costs. As such, the services often do not account for 15% of the total contract price.

Our own estimates are that 1-5% of opportunities competed under NAICS code 541519 truly reach the 15-50% services threshold. To support this claim, publicly held VARs report between 7-10% of their total revenue coming from services in their annual 10k reports. Assigning a new, applicable and more appropriate manufacturing NAICS code instead of using this exception would increase small business participation, increase supplier qualifications and benefit the customer by more competitive pricing.

Ultimately, where a small business contractor is not compliant with the SBA regulations, it is susceptible to size protests, potential suspension or debarment, or False Claims Act liability. Relatedly, if a small business submits a bid or proposal for a small business set-aside contract based on a false statement about its size or status, this is likely to be viewed as a *willful and intentional* false certification.⁴⁴ Willfulness is an important element for finding liability under the False Claims Act, and can lead to treble damages.⁴⁵ Thus, simply by submitting a proposal where the business cannot comply with the NMR, or with the 15-50% service requirement under the ITVAR Code – even in situations where the contractor did not understand or know the rules – a small business contractor could potentially expose itself to False Claims Act liability (including treble damages), suspension or debarment, a size-based protest by a competitor, contract termination, and loss of business.

V. Proposed Solutions

As discussed above, the current system for classifying and executing procurements involving ITVARs has serious flaws that should be addressed. Any comprehensive solution must (1) recognize what ITVARs actually do (*i.e.*, the type and mix of services and products they provide); (2) capture and account for how services currently are billed to the government; (3) provide a realistic size standard that is not over- or under-inclusive; and (4) address head-on the NMR for COTS IT procurements.

⁴⁴ See 13 C.F.R. § 121.108(b) (Submission of a bid or proposal for a contract that is set aside for award to small businesses “shall be deemed affirmative, willful and intentional certifications of small business size and status.”)

⁴⁵ 31 U.S.C. § 3729(a)(1)(A).

While there are a number of possible solutions, the most viable and sensible solution is to create a new NAICS code that accurately captures the core competency of the ITVAR, accompanied by creation of an appropriate SBA size standard and elimination of the IT Value Added Reseller exception under SBA's size standard for NAICS code 541519, at Footnote 18. The new code should focus on the ITVAR's role as a consultant that provides pre-sales engineering and subject matter expertise on a variety of software and hardware products.

With respect to qualifying as a small business under the new NAICS code, the SBA should ensure the size standard is appropriate and acknowledge that the NMR is explicitly inapplicable. Recognizing that ITVARs typically operate on low margins even though their annual receipts may be high, the size standard should be based on employee count rather than annual revenue. A reasonable size standard for the new code is 500 employees.

Relatedly, because ITVARs by definition do not manufacture the products they resell, it is nonsensical to require ITVARs to comply with the NMR – particularly where solicitations overwhelmingly seek COTS items manufactured by large businesses. For example, requiring an acquisition of Dell computers from an ITVAR to comply with the NMR is impractical. The ITVAR code and the Software code (513210, Footnote 15) both require compliance with the NMR, but allow for waivers of the NMR. In short, rather than eliminating the NMR with respect to procurements using these codes, the SBA opted to put the onus on agencies to seek waivers. In practice, this is not a viable solution, as shown by how ineffective and underutilized it has been to date. As discussed in Section IV.B. above, contracting officers have been reluctant to request contract specific waivers prior to issuing solicitations and, to date, no class waivers for software have been granted.⁴⁶

Importantly, the SBA size standard associated with the new NAICS code must not include a service requirement that is based on a percent of the total contract price, but should embrace a service requirement based on the distinct, robust value-added services provided by a typical ITVAR.⁴⁷ The current ITVAR 15-50% services requirement ignores the reality that (1) the fixed cost of the component *far* exceeds the cost of the services and implementation of equipment, and (2) the provided services generally are not separately billed. As detailed in Section II, ITVARs provide valuable services to the Government, but the costs of those services are included in overhead costs, covered by narrow margins on the IT products, and not separately charged. Therefore, the current requirement that services account for 15-50% of the total contract price is unattainable and should be eliminated under the new code and size standard.

Ideally, the Office of Management and Budget and Economic Classification Policy Committee will create a new, stand-alone NAICS code for IT value-added resellers. Once

⁴⁶ See Section IV.B above for discussion regarding why a class waiver for software under NAICS code 513210Footnote 15 is appropriate. Further, even if a small business manufactures a certain COTS software, the Government is unlikely to be willing or able to purchase it due to, *e.g.*, compatibility issues with existing Government systems and/or stringent security requirements (*e.g.*, FedRAMP or the Cybersecurity Maturity Model Certification (“CMMC”). This obviates the purpose of the NMR for these small business COTS software acquisitions.

⁴⁷ Alternatively, if the services continue to be measured in terms of total contract price, the required percent should be reduced and there must be a requirement that the contract include a CLIN to allow for services to be separately billed to the Government.

established, the SBA should then revise its current size standards accordingly and eliminate 541519 Footnote 18. The new NAICS code description (suggested as code 541520) should include the following language –

541520 – Information Technology Value-Added Reseller (ITVAR) Services

This U.S. industry comprises establishments primarily engaged in providing a total solution to information technology acquisitions by providing commercially available multi-vendor hardware and software items manufactured by original equipment manufacturers (OEMs), along with significant value-added services. The value-added services are the primary function of the ITVAR and are provided both before and after the item reaches the end-user. Significant value added services consist of, but are not limited to, configuration consulting and design, systems integration, installation of multi-vendor computer equipment, customization of hardware or software, training, product technical support, maintenance, and end user support.

As soon as practicable after this new NAICS code is implemented, SBA should revise its size standards to account for the new NAICS code and institute an appropriate employee-based size standard of 500 employees.⁴⁸

VI. Conclusion

Small business ITVAR participation is critically important to the federal government's ability to acquire and implement COTS IT solutions. Yet, a patchwork of rules and regulations specific to small businesses and the IT industry have led to frequent misclassification of IT procurements and have made it challenging, and in some cases impossible, for small business ITVARs to participate without potentially violating the law. The current landscape clearly demonstrates the need for a more complete solution. Creating a new NAICS code and associated size standard, specifically tailored to meet the requirements of the Government and to account for the unique aspects of the ITVAR industry, would enable contractors to provide the best possible solutions with respect to IT procurements.

Thank you for considering my testimony on these important matters. I applaud the Committee's effort to address these issues and look forward to future opportunities to share my input on ways Congress can support small businesses as they continue to grow.

⁴⁸ As explained above, SBA should exempt this size standard from NMR compliance.