Although the Finance Board anticipates that the proposed rule will be of benefit primarily to small depository institutions, it will not have a disproportionate impact on small entities. Therefore, in accordance with the Regulatory Flexibility Act, the Finance Board hereby certifies that this proposed rule, if promulgated as a final rule, will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b).

### IV. Paperwork Reduction Act

The proposed rule does not contain any collections of information, as defined by the Paperwork Reduction Act of 1995. See 44 U.S.C. 3501 *et seq.* Consequently, the Finance Board has not submitted any information to the Office of Management and Budget for review.

### List of Subjects

*12 CFR Part 933*

Federal home loan banks, Reporting and recordkeeping requirements.

*12 CFR Part 935*

Credit, Federal home loan banks, Reporting and recordkeeping requirements.

Accordingly, the Federal Housing Finance Board hereby proposes to amend title 12, chapter IX, parts 933 and 935 of the Code of Federal Regulations as follows:

## PART 933—MEMBERS OF THE BANKS

1. The authority citation for part 933 continues to read as follows:

**Authority:** 12 U.S.C. 1422a, 1422b, 1424, 1426, 1430, 1442.

2. Amend § 933.1 by revising paragraph (n)(1)(iii), removing ''or'' at the end of paragraph (bb)(6)(iii), removing the period at the end of paragraph (bb)(7) and adding ''; or'' in its place, and adding paragraph (bb)(8) to read as follows:

**§ 933.1 Definitions.**

* * * * *

(n) *Home mortgage loan* * * *

(1) * * *

(iii) Combination business or farm property, on which is located a permanent structure actually used as a residence, other than for temporary or seasonal housing; or

* * * * *

(bb) *Residential mortgage loan* * * *

(8) Loans that finance properties or activities that, if made by a member, would satisfy the statutory requirements for the Community Investment Program established under section 10(i) of the Bank Act, or the regulatory requirements established for any community investment cash advance program authorized by section 10(j)(10) of the Bank Act.

* * * * *

## PART 935—ADVANCES

1. The authority citation for part 935 continues to read as follows:

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a)(1), 1426, 1429, 1430, 1430b, and 1431.

2. Amend § 935.1 by revising paragraph (1)(v) in the definition of ''Residential real property'' to read as follows:

**§ 935.1 Definitions.**

* * * * *

*Residential real property* * * *

(1) * * *

(v) Combination business or farm property, on which is located a permanent structure actually used as a residence, other than for temporary or seasonal housing.

* * * * *

Dated: September 10, 1997.

By the Board of Directors of the Federal Housing Finance Board.

**Bruce A. Morrison,**

*Chairperson.*

[FR Doc. 97–26893 Filed 10–10–97; 8:45 am]

BILLING CODE 6725–01–U

## SMALL BUSINESS ADMINISTRATION

## 13 CFR Part 107

## Small Business Investment Companies

**AGENCY:** Small Business Administration.

**ACTION:** Proposed rule.

**SUMMARY:** Title II of Public Law 104–208 (September 30, 1996), entitled the ''Small Business Programs Improvement Act of 1996'', made a number of changes to the Small Business Investment Act of 1958, as amended. For the Small Business Investment Company program, these changes include provisions affecting capital requirements, Leverage eligibility and fees, and the status of Section 301(d) Licensees. This proposed rule would implement the statutory provisions; in addition, it would make various technical corrections and clarifications, as well as changes intended to improve the fairness and flexibility of the regulations.

**DATES:** Comments must be submitted on or before November 13, 1997.

**ADDRESSES:** Written comments should be addressed to Don A. Christensen, Associate Administrator for Investment, U.S. Small Business Administration, 409 3rd Street, S.W., Suite 6300, Washington, D.C. 20416.

**FOR FURTHER INFORMATION CONTACT:** Leonard W. Fagan, Investment Division, at (202) 205–7583.

**SUPPLEMENTARY INFORMATION:** This proposed rule would implement the provisions of Title II of Public Law 104–208 (September 30, 1996) which relate to small businesses investment companies (SBICs). This rule would also make certain other substantive changes, clarifications and technical corrections to the regulations governing SBICs, including those concerning portfolio diversification, Cost of Money, and the computation of distributions to be made by SBICs that have issued Participating Securities.

### Section 301(d) Licensees

Prior to October 1, 1996, an SBIC program applicant could be licensed under either section 301(c) or section 301(d) of the Small Business Investment Act of 1958, as amended (Act). A Section 301(d) Licensee, also known as a ''specialized SBIC'' or ''SSBIC'', agreed to invest only in businesses owned and controlled by socially or economically disadvantaged individuals. In return, a Section 301(d) Licensee received certain benefits not available to other SBICs, such as eligibility for certain types of subsidized Leverage (as defined in § 107.50).

Effective October 1, 1996, section 208(b)(3) of Public Law 104–208 repealed section 301(d) of the Act. However, the repeal provision was accompanied by the following language: ''The repeal * * * shall not be construed to require the Administrator to cancel, revoke, withdraw, or modify any license issued under section 301(d) of the Small Business Investment Act of 1958 before the date of enactment of this Act.''

This proposed rule would revise several sections in part 107 to implement this statutory change. The revisions would eliminate provisions relating to the licensing of new SSBICs while retaining rules governing the operations of existing SSBICs.

Thus, in § 107.50, a ''Section 301(d) Licensee'' would be defined as ''a company licensed prior to October 1, 1996 under section 301(d) of the Act as in effect on the date of licensing, that may provide Assistance only to Disadvantaged Businesses.'' Current § 107.110, which deals with organization of a section 301(d) license applicant, would be removed. Similarly, § 107.120 would be revised by

eliminating references to the licensing of an SSBIC to operate as the subsidiary of another Licensee or group of Licensees. Any existing SSBIC which was licensed as a subsidiary would be permitted to continue its operations under the same conditions as before; however, the proposed rule would not allow an existing SSBIC that is not already a subsidiary of another Licensee to become one. SBA has noted no demand on the part of existing Licensees to reorganize in this fashion.

The proposed revision of § 107.230(d)(4) would eliminate future use of the provision which allowed Section 301(d) Licensees to include in their Private Capital, without limitation, funds indirectly obtained from State or local government sources. Under the proposed rule, such funds would be included in Private Capital only if they were invested in or committed in writing to the Licensee prior to October 1, 1996. Otherwise, Section 301(d) Licensees would be limited to State and local government funds equal to 33 percent of their Regulatory Capital under current § 107.230(d)(3), which applies to all Licensees. This change is necessary to bring the regulations into conformity with the Act as amended by Public Law 104–208.

Other proposed changes reflect amendments to the Act which eliminated subsidized SBA Leverage. Such Leverage was previously available to SSBICs in the form of Debentures with an interest rate subsidy or Preferred Securities with a 4 percent dividend. Although subsidized Leverage can no longer be issued, the Act does not require SSBICs to prepay or redeem such Leverage prior to its scheduled maturity. In addition, an SSBIC may apply for any type of non-subsidized Leverage (Debentures or Participating Securities) for which it is eligible.

To implement these changes, current §§ 107.1100 and 107.1110 would be condensed into proposed § 107.1100. The proposed section would eliminate the separate descriptions of the types of Leverage available to Section 301(c) and Section 301(d) Licensees and would eliminate all references to subsidized Leverage.

SBA is also proposing revisions to § 107.1160 in order to conform with the Act. The entire section, which sets forth conditions governing the issuance of Leverage by a Section 301(d) Licensee, would apply only to Leverage issued on or before September 30, 1996. After that date, a Section 301(d) Licensee would be eligible to apply for Leverage under § 107.1150, subject to the same terms and conditions as other Licensees.

Similarly, the proposed revisions to the definition of ''Preferred Securities'' in § 107.50 and to §§ 107.1400, 107.1420 and 107.1430 reflect the fact that SBA's authority under the Act to purchase Preferred Securities ceased as of October 1, 1996. The appropriation of funds for such securities actually ended as of October 1, 1995, but some Preferred Securities were issued in fiscal year 1996 by Licensees drawing against SBA's commitments of fiscal year 1995 funds.

Finally, the provisions of current § 107.1350 which allow a Section 301(d) Licensee to retire certain Debentures by issuing Preferred Securities would be eliminated. The remainder of the section, dealing with the retirement of Debentures through the issuance of Participating Securities, would be redesignated as § 107.1585 and would apply to both SBICs and SSBICs.

**Common Control**

''Common Control'' as defined in § 107.50 currently means ''a condition where two or more Licensees, either through ownership, management, contract, or otherwise, are under the Control of one group or Person.'' However, the defined term as used in paragraphs (4) and (5) of the definition of ''Associate'' is clearly intended to refer to Persons other than Licensees. To accommodate this usage, the proposed rule would revise the Common Control definition to refer to ''two or more Persons'' rather than ''two or more Licensees''. The portion of the definition under which certain circumstances establish a presumption of Common Control would continue to apply only to two or more Licensees.

**Management and Ownership Diversity**

Section 208(c)(3) of Public Law 104–208 amended the Act to require that new SBICs have diversity between management and ownership. For any SBIC licensed on or after September 30, 1996, SBA must ensure that the management ''is sufficiently diversified from and unaffiliated with the ownership of the licensee in a manner that ensures independence and objectivity in the financial management and oversight of the investments and operations of the licensee.'' SBA has required diversity between management and ownership since 1994 for Participating Securities issuers and since 1996 for other new leveraged Licensees. Therefore, in response to the new statutory requirement, SBA is proposing only minor changes to improve the effectiveness of § 107.150.

Under current § 107.150(a), a Licensee or license applicant can demonstrate diversity if at least 30 percent of its Regulatory Capital is held by at least three shareholders or limited partners (or one acceptable Institutional Investor) unrelated to management. Specifically, these investors cannot be Associates of the Licensee or applicant, or Affiliates of any of its Associates. The proposed rule would retain these concepts, but would eliminate the phrase ''Affiliate of an Associate''. Instead, proposed § 107.150(a) would specify that to qualify for diversity purposes, an investor must not be an Associate of the Licensee or applicant and must not ''Control, be Controlled by, or be under Common Control with'' an Associate. SBA does not intend for this language to be substantively different from the current language, but believes that readers may find it easier to understand. In addition, the proposed rule would address certain other characteristics of ''diversity investors'' which are not covered in the current regulation, but which SBA considers important.

Proposed § 107.150(a) would specify that the investors relied upon to satisfy the diversity requirement cannot be Affiliates of one another. SBA believes that if such investors are related parties, the requirement that there be at least three of them is rendered essentially meaningless. The proposed rule also would give SBA discretion to reject for diversity purposes an investor whose ownership interest is not significant, either in terms of absolute dollars or percentage of ownership. This provision underscores the purpose of the diversity rules, which is to encourage the presence of investors who are likely to have a serious interest, similar to SBA's, in the fair and prudent management of the SBIC.

The proposed changes reflect policies which SBA has been developing in its review of license applications. In particular, SBA has used informal internal guidelines to evaluate whether a proposed investor's interest is substantial enough to qualify for diversity purposes. SBA is continuing to refine these guidelines and expects to incorporate them into its standard operating procedures.

**Capital Requirements**

Under the Act as amended by section 208(c) of Public Law 104–208, SBICs licensed on or after October 1, 1996 must meet increased minimum capital requirements. Previously, the statutory minimum capital requirement was $2.5 million. The new requirements would be implemented in proposed § 107.210, which combines and revises elements of current §§ 107.210 and 107.220. Proposed § 107.210(a)(1) would require

a company that does not wish to be eligible to issue Participating Securities to have Regulatory Capital of at least $5,000,000. As an exception to this general rule, SBA would be able to license an applicant with Regulatory Capital of at least $3,000,000, but only if the applicant meets certain conditions set forth in the proposed regulation. As mandated by the Act, this exception is limited to those instances where ''special circumstances and good cause'' can be shown.

Proposed § 107.210(a)(2) contains essentially the same language as the current § 107.220(a). It would require a company licensed on or after October 1, 1996, that wishes to be eligible to apply for Participating Securities to have Regulatory Capital of at least $10,000,000, with a permitted exception for an applicant which demonstrates to SBA's satisfaction that it can be financially viable over the long term with a lower amount (but under no circumstances less than $5,000,000). SBA regulations have required this level of Regulatory Capital for Participating Securities issuers since 1994.

The proposed rule would not permit prospective Participating Securities issuers to be licensed pursuant to the exception available to other applicants, under which a license may be granted with Regulatory Capital as low as $3,000,000. For applicants planning to issue Participating Securities, SBA believes that the ability to meet the standard minimum capital requirement is an important indicator of the credibility of management. SBA also doubts that any such applicant can demonstrate financial viability with Regulatory Capital of only $3,000,000, even on a temporary basis.

In addition to the Regulatory Capital requirements described above, proposed § 107.210(a) would also require any company licensed on or after October 1, 1996, to have Leverageable Capital of at least $2,500,000. Leverageable Capital is a subset of Regulatory Capital; while both include capital actually contributed to a Licensee by its private investors, the major difference between them is that Regulatory Capital also includes the Licensee's unfunded binding commitments from Institutional Investors. The proposed rule, which is consistent with SBA's current licensing policy, reflects the Agency's belief that the presence of a certain minimum level of Leverageable Capital demonstrates an applicant's seriousness and readiness to operate actively as an SBIC.

The proposed rule would not require SBICs licensed before October 1, 1996 to increase their capital. Under proposed § 107.210(b), such companies would have to meet the applicable minimum capital requirements under the regulations in effect on September 30, 1996 (see §§ 107.210 and 107.220 as in effect on that date). These requirements vary depending upon the date a company was licensed and the type of SBA Leverage it has issued or wants to issue.

See also the section of this preamble entitled ''Eligibility for Leverage and Leverage Commitments''.

**Valuations**

Section 208(f)(2) of Public Law 104–208 included one provision related to the valuation of portfolio securities held by Licensees which was not already reflected in the regulations. Under this provision, as part of the annual audit of a Licensee's financial statements, the independent auditor must provide to SBA a statement that the Licensee's valuations were performed in accordance with its SBA-approved valuation policy, as required by section 310(d)(2) of the Act. SBA has included this requirement in proposed § 107.503(e). SBA is also proposing various non-substantive wording changes in § 107.503 to improve the clarity of the section.

**Reports To Be Filed With SBA**

Current § 107.660 requires an SBIC to provide SBA with copies of reports given to its investors or filed with the Securities and Exchange Commission, and to notify SBA when it becomes a party to litigation or other proceedings. Proposed § 107.660(d) would add a requirement for a Licensee to notify SBA if an officer, director, general partner or other Control Person is charged with or convicted of any criminal offense other than a misdemeanor involving a minor motor vehicle violation. Key personnel associated with a license applicant currently must provide this type of information as part of the personal history statement included in the SBIC license application. The purpose of the proposed rule is to give SBA a mechanism for updating such information as needed to ensure the integrity of the SBIC program.

**Financing of Smaller Enterprises**

Since April 1994, SBICs have been required to direct a certain percentage of their investment activity to businesses which fall significantly below the maximum size permitted for a Small Business. These businesses were originally referred to as ''Smaller Businesses'', a term which was changed to ''Smaller Enterprises'' in a final rule published in the **Federal Register** on March 13, 1997 (62 FR 11759).

Under proposed § 107.710, the basic requirement for a Licensee to invest at least 20 percent of the total dollar amount of its Financings in Smaller Enterprises would remain unchanged. However, proposed § 107.710(c) would add a new requirement to implement section 208(c)(2) of Public Law 104–208. This provision applies to SBICs licensed on or before September 30, 1996, which issue Leverage after that date and which do not meet the current minimum capital requirement (Regulatory Capital of at least $5,000,000 for Debentures or at least $10,000,000 for Participating Securities). For such Licensees, at least 50 percent of the aggregate dollar amount of their Financings extended after September 30, 1996 must be invested in Smaller Enterprises. As a practical matter, SBA has found that Licensees to which this requirement applies typically invest almost exclusively in Smaller Enterprises.

Like the current regulation, the proposed rule would measure compliance with the requirements to finance Smaller Enterprises as of the end of a Licensee's fiscal year. Under current § 107.710(e), a Licensee which has not achieved the required percentage of investments in Smaller Enterprises is allowed one additional year to bring its portfolio into compliance. The proposed rule would retain this provision. However, such a Licensee would not be eligible for additional Leverage until it reaches the required percentage. See also the section of this preamble entitled ''Eligibility for Leverage and Leverage Commitments''.

**Passive Businesses**

SBICs are generally prohibited from investing in passive businesses. However, an exception is provided for holding companies which pass through the financing proceeds to an active subsidiary. The precise nature of this exception has changed over time. Prior to 1996, the general prohibition did not apply ''to any Small Concern wholly owning another eligible Small Concern engaged in a regular and continuous business operation.'' Under current § 107.720(b)(2), which became effective January 31, 1996, an SBIC may finance a passive business ''if, for all Financings extended, it passes substantially all the proceeds through to the same eligible Small Business that is not passive.''

The goal of the 1996 revision was to eliminate the requirement for the passive business to be the 100 percent owner of the operating business, while still ensuring some substantial relationship between the two by

allowing funds to be passed through to only one active entity. SBA now believes that the latter provision may unnecessarily restrict some Small Businesses. For example, a holding company may be established with two operating subsidiaries, one engaged in manufacturing and the other in distribution of the manufactured product. Under the current regulation, if the holding company received financing from an SBIC, it could pass through the proceeds to only one subsidiary, even though both subsidiaries are essentially components of the same business.

At the same time, SBA continues to believe that there must be a significant relationship between a financed passive business and the active business which ultimately receives the proceeds. To satisfy this goal, proposed § 107.720(b)(2) would permit financing of a passive Small Business if it passes substantially all the proceeds through to one or more ''subsidiary companies'', defined as companies in which the financed passive business owns at least 50 percent of the voting securities. The current provision limiting the pass-through of proceeds to only one Small Business would be eliminated.

**Co-Investment With Associates**

Licensees may co-invest with Associates, subject to the conditions in § 107.730(d). This section sets forth certain circumstances under which the terms of a co-investment are presumed to be fair and equitable to the SBIC, so that no specific demonstration of equity is required. Under current § 107.730(d)(3)(iv), this presumption applies to co-investments by two non-leveraged SBICs. The proposed rule would apply the same presumption to co-investments by a non-leveraged SBIC and its non-SBIC Associate. The rationale behind the presumption is the same in both cases: SBA has no financial exposure, and is therefore unconcerned that a Licensee may be disadvantaged relative to its Associate.

**Portfolio Diversification Requirements**

Under current § 107.740, a leveraged SBIC may not have more than 20 percent of its Regulatory Capital invested in or committed to a single Small Business or group of related businesses, unless SBA gives its prior written approval (for SSBICs, the limit is 30 percent of Regulatory Capital). The purpose of this ''overline'' limit is to avoid excessive risk by ensuring a certain degree of portfolio diversification.

Since the beginning of the Participating Securities program, SBA has been aware that the current regulation may have an unintended effect. Participating Securities issuers operate under detailed rules governing distributions to SBA as well as to their private investors. These regulations permit a Licensee to return capital to its non-SBA partners under certain conditions, thereby reducing its Regulatory Capital and overline limit. SBA is concerned that a Licensee in these circumstances may suddenly have multiple violations of the overline regulation, even though its portfolio was sufficiently diversified based on its original Regulatory Capital.

To address this problem, proposed § 107.740(a) would base a Licensee's maximum permitted investment in or commitment to a Small Business on its Regulatory Capital at the time the investment or commitment is made. The limit would apply to the total amount of Financings and Commitments extended to the Small Business by the Licensee. For example, if a Licensee had invested $1,000,000 in a Small Business and wanted to provide follow-on financing at a time when its Regulatory Capital was $8,000,000, the amount of the follow-on financing could not exceed $600,000 (20 percent of $8,000,000, minus the $1,000,000 already invested).

It should be noted that the proposed rule would require a Licensee to be in compliance at the date of a Commitment and at the date of a Financing. Thus, a Licensee preparing to fund a Commitment it had made to a Small Business must ensure that it has sufficient Regulatory Capital as of the closing date to support the completed Financing.

Proposed § 107.740(a) would continue to permit overline investments with the prior written approval of SBA.

**Cost of Money**

Current § 107.855 sets forth limits on interest rates and other charges that SBICs may impose on Small Businesses. SBA is proposing three changes to these ''Cost of Money'' rules. The first change reflects section 208(d)(6) of Public Law 104–208, under which SBICs must pay to SBA an additional charge of 1 percent per year on any Leverage issued after September 30, 1996 (except for draws against commitments made by SBA in fiscal year 1996). The proposed rule would allow a Licensee to include this charge in its base rate when computing its Cost of Money ceiling. The base rate would be equal to either the current Debenture Rate plus the 1 percent charge (see § 107.855(c)), or the Licensee's own Cost of Capital with the 1 percent charge treated as additional interest expense in the computation (see § 107.855(d)). Although this change may increase the cost of borrowing for some Small Businesses, SBA believes that it is warranted because it reflects the increase in Licensees' cost of funds. There would be no change in the basic Cost of Money limitations of 19 percent for Loans and 14 percent for Debt Securities which Licensees may use regardless of the level of prevailing interest rates.

For Section 301(d) Licensees which elect to compute a Cost of Money ceiling based on their own Cost of Capital, proposed § 107.855(d)(4) would clarify that interest expense on a subsidized SBA-guaranteed debenture may be computed using the debenture's face (unsubsidized) interest rate. This provision was inadvertently deleted when the regulations were revised in January 1996, but has since remained in effect as a matter of SBA policy.

Finally, SBA is proposing to clarify the treatment of warrants with respect to Cost of Money. The regulations governing Cost of Money apply to Loans (which have no provision for obtaining equity in a Small Business) and Debt Securities (which involve some type of equity feature). SBA generally interprets these rules to exclude from Cost of Money any returns realized on the equity portion of a Debt Security because such returns normally are neither assured nor predictable. However, SBA has become aware of certain situations under which the current regulations may effectively require inclusion of the value of warrants in Cost of Money.

This may occur when a Licensee lends cash to a Small Business, and receives in return not only a note for the amount lent, but also detachable warrants to acquire equity in the Small Business. Generally accepted accounting principles require the Licensee to determine the fair value, if any, of the warrants received and to record the warrants at that value, while discounting the note by the same amount. The discount is then amortized to interest income over the life of the note. Under current § 107.855(f), the income created through amortization of the discount is included in Cost of Money.

SBA believes that this provision unduly disadvantages SBICs which allocate substantial value to the warrants acquired, relative to SBICs which assign zero or nominal value. Typically, SBICs invest in private companies which have no readily ascertainable market value. Thus, the value allocated to such companies' warrants is often determined through negotiation rather than the application of precise methods. Given the level of

uncertainty associated with such valuations, SBA prefers to create a level playing field in which all returns realized on detachable warrants are excluded from Cost of Money.

Proposed § 107.855(g)(1) would address this concern by allowing a specific exclusion from Cost of Money for a discount on the loan portion of a Debt Security, if the discount results solely from the allocation of fair value to detachable stock purchase warrants as required by generally acceptable accounting principles. Discounts in general would still be included in Cost of Money. For example, if a Licensee provided $1,000,000 to a Small Business and received a note for $1,100,000, the amortization of the $100,000 discount over the life of the note would be treated as additional interest income for Cost of Money purposes.

**Control**

Proposed § 107.865 contains two clarifications to the existing regulation concerning Control of a Small Business by an SBIC. Under current § 107.865(c), a Licensee can rebut a presumption of Control if certain criteria concerning the ownership of the Small Business and the composition of its board of directors are satisfied. The proposed rule would eliminate references to the rounding of percentages in determining whether the board of directors meets the established criteria. The current language is confusing because it is unclear how the rounding is to be applied; SBA believes that removing it would permit a plain reading of the regulation.

The second proposed clarification involves current § 107.865(d), which sets forth the conditions under which a Licensee may take temporary Control of a portfolio company. The proposed rule would permit such Control where reasonably necessary for the protection of a Licensee's existing investment; the only revision is the addition of the word ''existing''. The proposed language is not a substantive change; it is intended simply to make explicit SBA's long-standing interpretation of this provision.

**Eligibility for Leverage and Leverage Commitments**

Section 208 of Public Law 104–208 established certain requirements which an SBIC must satisfy in order to obtain SBA Leverage. Proposed § 107.1120 (c) and (d) would implement these requirements. An SBIC licensed after September 30, 1996, with Regulatory Capital of less than $5,000,000 would be ineligible for Leverage until it reached the $5,000,000 level. An SBIC licensed on or before September 30, 1996, would not be required to increase its capital in order to obtain additional Leverage; however, if its Regulatory Capital was less than $5,000,000 ($10,000,000 for a company seeking to issue Participating Securities), it would have to certify in writing that at least 50 percent of the aggregate dollar amount of its Financings extended after September 30, 1996 would be provided to Smaller Enterprises (see also proposed § 107.710(c)). Finally, any Licensee seeking Leverage would be required to certify in writing that it is in compliance with the general requirement to provide 20 percent of its total Financings to Smaller Enterprises under § 107.710(b).

SBICs can obtain Leverage by applying directly for funding when it is needed or by obtaining a Leverage commitment from SBA which it can draw down over a period of time. SBA is proposing minor changes to the current rules governing the commitment process. The proposed rule would eliminate the minimum and maximum amounts for a Leverage commitment in current § 107.1200(c). SBA believes that these limits are unnecessary. Under the proposed rule, commitment amounts would have to be in multiples of $5,000 to accommodate requirements of the Leverage funding process; in all other respects, the amount of a commitment would be at SBA's discretion. Similarly, the current limitations in § 107.1230(b) on the amount that a Licensee can draw against its commitment would be eliminated. The proposed rule would require draws, like commitments, to be in multiples of $5,000; in addition, SBA would have discretion to determine a minimum draw amount, and would publish notice of any such determination in the **Federal Register** from time to time.

**Leverage Fees**

SBA is proposing changes in §§ 107.1130 and 107.1210 to implement provisions of section 208(d)(6) of Public Law 104–208 which affect the fees SBICs must pay in order to obtain SBA Leverage. These fee changes were effective October 1, 1996, and were implemented on an interim basis by SBA Policy Notice 1000–6.

Under proposed § 107.1130, a Licensee would pay a nonrefundable ''leverage fee'' to SBA when Debentures or Participating Securities are issued. The fee is 3 percent of the face amount of the Leverage issued, replacing the 2 percent user fee and the 1 percent commitment fee previously in effect. If a Licensee receives a Leverage commitment from SBA, it must prepay the 3 percent fee at the time it receives the commitment (see proposed § 107.1210(a)); otherwise, the fee is payable when the Leverage is issued.

Proposed § 107.1130(d) would require a Licensee to pay to SBA an additional ''Charge'' on Debentures and Participating Securities (see also § 107.50 for the definition of this proposed new term). For both types of Leverage, the Charge is 1 percent per annum. The Charge is payable under the same terms and conditions as the interest on Debentures or the Prioritized Payments on Participating Securities, as applicable. Thus, a Debenture issuer would pay the Charge in two semi-annual installments together with its interest payments. In contrast, a Participating Securities issuer would pay the Charge only when it had profits and was distributing Prioritized Payments under § 107.1540. The Charge would not apply to Leverage drawn down against a commitment obtained from SBA on or before September 30, 1996.

**Participating Securities—General**

SBICs began to issue Participating Securities in 1995. As Licensees and SBA have gained experience with the program, there have been a number of regulatory changes intended to correct errors and to eliminate inconsistencies and confusing language. The proposed rule continues this process of correction and clarification, and also includes certain substantive changes.

Current § 107.1500 sets forth general terms and conditions of the Participating Security. One of these conditions, set forth in § 107.1500(b)(4), is that a Licensee must make Equity Capital Investments equal to the amount of Participating Securities it issues, and must maintain such investments in an amount equal to its outstanding balance of Participating Securities. The proposed rule would implement a provision of Public Law 104–208 by eliminating the maintenance requirement. Thus, a Licensee would be responsible only for investing the appropriate dollar amount in Equity Capital Investments, and would not have to be concerned with the timing of the liquidation of those investments. The same change would also be reflected in proposed § 107.1820, which sets forth conditions that an SBIC must comply with in connection with its issuance of Participating Securities. In this section, under paragraph (e)(9), the failure to maintain a specified amount of Equity Capital Investments would be eliminated from the list of Restricted Operations Conditions.

Proposed § 107.1500(e), concerning amounts to be paid upon redemption of Participating Securities, includes the

new 1 percent annual Charge on Leverage issued on or after October 1, 1996 (see the section entitled ''Leverage Fees'' in this preamble). Proposed § 107.1500(f), concerning the priority of Participating Securities when a Licensee liquidates, reflects the same change. In addition, this paragraph would clarify that only Earned Prioritized Payments (that is, those Prioritized Payments which the Licensee has sufficient profits to pay) have priority in liquidation; the Licensee has no obligation to pay Accumulated Prioritized Payments (those not covered by available profits).

**Liquidity Requirements for Participating Securities**

The proposed rule includes two minor changes to the liquidity requirements in § 107.1505. Currently, a Licensee must perform the liquidity impairment computation at the end of its fiscal year, when it applies for Leverage, and when it intends to make a Distribution. Under proposed § 107.1505(a)(2), SBA would be able to exempt a Licensee applying for Leverage from the computation requirement. SBA has found that many SBICs in the early stages of their existence are extremely liquid; in these cases, the Agency believes that the formal liquidity computation provides no additional useful information and need not be performed.

The second proposed change involves the computation of the liquidity ratio in § 107.1505(b). Various components of the ratio are assigned weights which reflect the ease and/or probability of their conversion to cash. One of the components of ''Total Current Funds Available'' (the numerator of the liquidity ratio) is Publicly Traded and Marketable Securities, as reported on SBA Form 468. Under the current regulation, a Licensee is given credit for 65 percent of the reported value of these securities in the liquidity computation. In contrast, the proposed rule would allow the Licensee to count 100 percent of the reported value as a source of liquidity. SBA is proposing this change because Licensees are expected to take appropriate discounts (for restrictions, large holdings relative to trading volume, etc.) when valuing their securities, as required by SBA's valuation guidelines for SBICs. Since these discounts are already reflected in the portfolio valuations reported on Form 468, SBA considers it unnecessary to discount these values further in the liquidity computation.

**Earmarked Profit (Loss)**

Under § 107.1510, Participating Securities issuers are required to compute Earmarked Profit (Loss) as a preliminary step in determining the amounts of various Distributions. SBA is proposing two changes to this section. The first would affect only a Licensee holding assets not subject to SBA Profit Participation (''non-Earmarked Assets''). For a hypothetical SBIC in this situation (none are currently licensed), the proposed rule would simplify the computation of the ''Earmarked Asset Ratio''. This ratio is intended to measure the proportion of the total portfolio which consists of Earmarked Assets, but is currently complicated by the inclusion of a factor described as ''weighted average uninvested proceeds of Participating Securities''. SBA believes that this amount would be extremely difficult, if not impossible, to compute in practice; even if it could be determined, it would have little effect on the resulting ratio because it is included in both the numerator and denominator. Therefore, SBA is proposing to eliminate this factor entirely from the Earmarked Asset Ratio computation in § 107.1510(c). The proposed rule would also simplify the Earmarked Asset Ratio formula by replacing ''weighted average'' Earmarked Assets and ''weighted average'' Loans and Investments with simple averages. The intent of this change is that the ''average'' amounts specified would represent average monthly balances, as computed by the Participating Securities software developed by SBA. The Agency believes this method provides reasonable precision without requiring detailed tracking of the number of days outstanding for each portfolio investment, as the weighted average method requires.

The other proposed change affecting the Earmarked Profit (Loss) computation is in § 107.1510(d)(1)(ii), which deals with the amortization of leverage fees paid to SBA and partnership syndication costs incurred by an SBIC. Currently, for the purpose of computing Earmarked Profit (Loss), such costs must be amortized over five years. The proposed rule would require amortization over not less than five years. This change would accommodate companies which amortize the fees over a longer period for financial statement purposes and would prefer not to make an additional adjustment when performing the required profit computations.

**Prioritized Payments**

Section 107.1520 tells a Licensee how to compute Prioritized Payments and how to determine whether it has profits which will cause Prioritized Payments to become ''earned'' and therefore payable to SBA. Three changes to this section are proposed. First, the proposed rule would implement a provision of Public Law 104–208 by including ''Charges'' (the 1 percent annual fee discussed in this preamble under the heading ''Leverage Fees'') on outstanding Participating Securities in the required computations. Although Charges are not part of Prioritized Payments, they are payable under the same terms and conditions, as set forth in the proposed section.

Second, the computation of profit for the purposes of § 107.1520 would be revised under proposed § 107.1520(d). Under the current regulations, a Licensee's ''profit'' equals its cumulative Earmarked Profit minus its cumulative Earned Prioritized Payments from prior periods. This computation ignores the fact that some or all of the profit computed in this manner may have already been distributed under other sections of the regulations, either to SBA as Profit Participation or to the Licensee's private investors. SBA received no comments addressing this concern when the regulations governing Participating Securities were originally proposed in April 1994 or revised in January 1996; nevertheless, the Agency is concerned that the current regulation may, in effect, place duplicate claims on the same income. The proposed rule would take prior profit distributions into account in determining whether a Licensee has profits which can be used to pay Prioritized Payments.

Third, proposed § 107.1520(f) would provide additional detail concerning the computation of Adjustments, a type of compounding of unpaid Prioritized Payments. The current regulation is written in general terms which do not explain exactly how certain amounts should be calculated. The proposed rule follows the method which is currently used in the software developed by SBA to perform the allocation and distribution computations required for Participating Securities.

**Profit Participation**

An SBIC which has issued Participating Securities must allocate Profit Participation to SBA when it has earned profits over and above the amount necessary to pay its Prioritized Payments in full. Under current § 107.1530, Profit Participation is determined by computing a ''Base'' and a ''Profit Participation Rate'', and multiplying the Base by the Rate. The proposed rule would modify both the Base and the Rate under certain circumstances.

The Base for Profit Participation represents a cumulative measure of a Licensee's Earmarked Profit after Prioritized Payments, Adjustments and Charges. A Participating Securities issuer must compute its Base as of the end of each fiscal year, but may also compute the Base for a period of less than one year in order to make an interim distribution of profits. If an SBIC elects to make such a distribution, it faces the possibility that the Profit Participation it pays to SBA for the interim period will be greater than the Profit Participation it would have been obligated to pay had it waited until the end of the fiscal year. This can happen because the SBIC suffers losses during the remainder of the year, or simply because additional Prioritized Payments accumulate during that time; either or both of these factors would reduce the SBIC's year-end Base. Under current § 107.1530(c), an SBIC which has paid ''excess'' Profit Participation under these conditions can treat the excess as ''Unused Loss'' at year end, thereby reducing the Base which it will use the next time it computes Profit Participation. However, this approach captures only a part of the SBIC's loss; the actual loss incurred between the interim distribution date and the fiscal year end is equal to the difference between the interim and year-end Bases, not just the Profit Participation computed on that difference. For this reason, SBA is concerned that the current regulation may impose a significant penalty on a Licensee which chooses to make an interim distribution, and may unduly distort an SBIC's decisions concerning the timing of distributions. Proposed § 107.1530(c) would allow a Licensee in the circumstances described to treat the full amount of the difference between its interim and year-end Bases as Unused Loss.

Most SBICs operate for a period of time before issuing Participating Securities; in some cases, companies are already investing actively even before they are licensed. In the computation of the Base, the current regulations do not address the question of whether net income or loss from fiscal years prior to the issuance of Participating Securities may be included. Under proposed § 107.1530(c)(3), a Licensee would be permitted to include prior losses in its Base with SBA approval, which would be required only once when the Licensee computes the Base for the first time. SBA expects to approve inclusion of prior losses in most cases, but is proposing the approval requirement to cover unusual circumstances, such as a company with non-Earmarked Assets or one which has operated for an extended period of time before issuing Participating Securities. The proposed rule does not discuss net income realized in prior fiscal years because SBA has not seen this situation in practice; the Agency considers this an unlikely occurrence which would be handled on a case by case basis.

The Profit Participation Rate is computed using a formula in which the key variable is the ratio of Participating Securities to Leverageable Capital (the ''PLC ratio''). Proposed § 107.1530(e) would retain the basic definition of the PLC ratio as the highest ratio of outstanding Participating Securities to Leverageable Capital that an SBIC has ever attained, as well as the exception which allows the ratio to be reduced if Leverageable Capital increases above its highest previous level, subject to certain conditions. Proposed § 107.1530(e)(2) (i) and (ii) would simplify the method for recomputing the PLC ratio following an increase in Leverageable Capital. The new PLC ratio would equal the highest dollar amount of Participating Securities the SBIC has ever had outstanding, divided by the SBIC's current Leverageable Capital. This computation would replace the present three-step method which is not only quite complex, but also can produce anomalous results when a Licensee's highest dollar amount of Participating Securities outstanding does not coincide with its highest ratio. SBA does not believe that any Licensee would be disadvantaged by this change.

After computing the Base and the Profit Participation Rate, an SBIC computes Profit Participation under § 107.1530(h). In the proposed rule, this paragraph has been reworded to improve its clarity. No substantive changes are proposed.

**Tax Distributions**

Limited partnership SBICs which have paid their Prioritized Payments in full and still have remaining Retained Earnings Available for Distribution are permitted to make an annual ''tax distribution'' to their investors, with SBA also receiving a share. Both the Act and § 107.1550 of the regulations use the term ''tax distribution'', based on the concept of allowing partnerships (or other flow-through entities) to distribute cash that investors can use to pay their taxes on the income allocated to them by the partnership. In practice, the permitted tax distribution may or may not correspond to a particular investor's actual tax liability, since the computation uses assumed rather than actual tax rates and does not distinguish between taxable and tax-exempt investors.

SBA is proposing one substantive change in § 107.1550(a)(1), which would be revised to include the 1 percent per annum Charge on Participating Securities issued on or after October 1, 1996 (except for those issued pursuant to a commitment obtained from SBA before that date). Under Public Law 104–208, Charges are payable as a preferred return to SBA under the same terms and conditions as Prioritized Payments; therefore, a Licensee must pay all its Prioritized Payments, Adjustments and Charges before it can make a distribution under § 107.1550.

The other proposed revisions in § 107.1550 are clarifications rather than substantive changes. In the formula used to compute a Licensee's Maximum Tax Liability, proposed § 107.1550(b)(1) would specify that Prioritized Payments allocated to SBA are to be excluded from the net ordinary income and capital gains allocated to partners. Proposed § 107.1550(b)(2) would clarify that while a Licensee may use either individual or corporate tax rates to compute Maximum Tax Liability, it must apply the same type of rate, either individual or corporate, to both ordinary income and capital gains. Finally, proposed § 107.1550(b)(3) would specify that in computing combined Federal and State tax rates to be used in the Maximum Tax Liability formula, a Licensee must assume that State income taxes are deductible for Federal income tax purposes. All of these changes are consistent with SBA's interpretation of the current regulations.

**Distributions Based on ''Retained Earnings Available for Distribution''**

As of the end of each fiscal year, if a Participating Securities issuer has Retained Earnings Available for Distribution (''READ'') remaining after paying all of its Prioritized Payments and making a tax distribution (if applicable), it must distribute the balance of READ in accordance with § 107.1560. SBA is proposing two clarifications to this section, as well as one minor substantive change.

Proposed § 107.1560 (a)(4) and (b)(1) would both be revised to clarify that the amount of READ to be distributed is determined after giving effect to any preceding distributions of Prioritized Payments under § 107.1540 and tax distributions under § 107.1550. The current regulation may not be clear on this point, although SBA has always interpreted it in a manner consistent with the proposed rule.

Current § 107.1560(e) contains a table which gives SBA's percentage share of

any distributions made under §§ 107.1560 or 107.1570(a). The heading of the first column refers to the Licensee's ''ratio of Leverage to Leverageable Capital as of the fiscal year end''. This heading is appropriate for distributions under § 107.1560, which are always computed as of the end of a fiscal year, but may be confusing for interim distributions under § 107.1570(a). If a Licensee makes an interim distribution, the intent of the regulations is to measure the ratio of Leverage to Leverageable Capital as of the end of the interim period for which the distribution is made. The proposed rule would clarify this point by replacing ''fiscal year'' with ''fiscal period'' in the column heading.

Proposed § 107.1560(a)(1) would be revised to include the 1 percent per annum Charge on Participating Securities issued on or after October 1, 1996. Under Public Law 104–208, Charges are payable as a preferred return to SBA under the same terms and conditions as Prioritized Payments; therefore, a Licensee must pay all its Prioritized Payments, Adjustments and Charges before it can make any other distribution under § 107.1560.

**Optional Distributions Not Based on READ**

A Licensee which has no READ may be able to make distributions to its private investors and SBA in accordance with § 107.1570(b). Distributions under this section are at the option of the SBIC and essentially constitute returns of capital. The current regulation sets forth conditions for making a distribution of this type. Under the proposed rule, two of these conditions would be revised. First, § 107.1570(b)(1)(i) would require an SBIC to pay any earned Charges, along with its Earned Prioritized Payments and earned Adjustments, before distributing under § 107.1570(b). This change is in accordance with section 208(d)(6) of Public Law 104–208; similar changes proposed in §§ 107.1550 and 107.1560 are discussed earlier in this preamble.

Second, under current § 107.1570(b)(1)(ii), a Licensee must have ''distributed all Profit Participation computed under § 107.1530'' before distributing under § 107.1570(b). This language may present a problem for an SBIC because of the following circumstances: Profit Participation is computed only on the basis of realized income or loss; however, the ability to distribute Profit Participation depends on the availability of READ, which also takes into account unrealized losses in a Licensee's portfolio. Thus, it is possible that a Licensee may compute Profit Participation to be allocated to SBA, but may be unable to pay it until some later date. Under these conditions, the Licensee would be blocked from distributing under § 107.1570(b). To remedy this situation, the proposed rule would require a Licensee to distribute Profit Participation only to the extent permitted based on its READ. SBA believes that the language in section 303(g)(10) of the Act, which requires payment of all Profit Participation ''due'' to SBA before a Licensee can return capital, provides sufficient flexibility to support this interpretation.

**Notice of Participating Securities Distributions**

The current regulations do not require SBICs with Participating Securities to notify SBA before making distributions. In practice, Licensees generally have sought SBA's assistance with the distribution calculations and have given SBA sufficient opportunity to review the results. Because of the complexity of some of the required computations, and the difficulty of correcting errors after a distribution takes place, SBA is proposing to formalize this practice. The proposed rule would require an SBIC to notify SBA 10 business days before a planned distribution under §§ 107.1540 through 107.1570, unless SBA permits otherwise. This language would give SBA the flexibility to allow distributions on shorter notice, if the circumstances warrant, without requiring Licensees to submit a formal request for a written exemption. SBA believes that this provision would not unreasonably constrain a Licensee's freedom of action and would provide important protection for Licensees as well as the Agency.

**Timing of Participating Securities Distributions**

The current regulations permit Participating Securities issuers to make distributions only on quarterly ''Payment Dates'' (February 1, May 1, August 1 and November 1 of each year). This structure was adopted to coincide with the terms of the public fundings of Participating Securities, under which investors receive interest payments and any returns of principal to which they are entitled on these dates. In the preamble to the final rule published on January 31, 1996 (61 FR 3177), SBA stated that it intended to seek a solution that would provide Licensees with greater flexibility in making distributions, particularly distributions in the form of securities.

Proposed § 107.1575 would allow an SBIC to make distributions (either in cash or in kind) on dates other than Payment Dates with SBA's prior written approval. SBA wishes to provide SBICs with as much flexibility as possible; however, for administrative and oversight purposes, the Agency feels strongly that it must have an opportunity to review planned distributions in advance.

Distributions based on fiscal year end results, such as required annual distributions of Prioritized Payments, would have to be made no later than the second Payment Date following the Licensee's fiscal year end. This requirement is consistent with the current regulation, which requires such distributions to be made on either the first or second Payment Date.

For any distribution made on other than a Payment Date, the distribution date would be used as the cutoff date for all the required computations (Earmarked Profits, Prioritized Payments, etc.). This approach may require a Licensee to perform a mid-month closing of its financial statements, which may not be as clean or convenient as a month-end closing. However, SBA believes it is the only approach which will accommodate all potential distributions, particularly distributions of securities on which realized gain cannot be recognized before the distribution date.

If a distribution to SBA includes a redemption of Participating Securities, the proposed rule specifies that the effective date of the redemption will be the next Payment Date following the distribution date. This provision is necessary because Participating Securities are funded through the purchase by investors of Trust Certificates, under which principal can be returned only on Payment Dates. Because of this structure, a Licensee will also be responsible for Prioritized Payments through the next Payment Date on the amount of Participating Securities to be redeemed.

**In-Kind Distributions by Licensees**

Participating Securities issuers are permitted to make distributions to SBA in the form of securities under the conditions set forth in § 107.1580. The current regulation limits in-kind distributions to those distributions required or permitted by §§ 107.1560 and 107.1570. Distributions of Prioritized Payments, which are governed by § 107.1540, must be made in cash. Because Prioritized Payments precede any other distributions, this limitation can have a potentially significant effect on the timing and value of distributions in general. To alleviate this concern, proposed § 107.1580(a) would allow distributions

under §§ 107.1540, 107.1560 and 107.1570 to be made in the form of securities. Distributions under § 107.1550 would continue to be permitted on a cash-only basis, since the stated purpose of such distributions is to provide investors in flow-through entities with sufficient cash to pay their anticipated tax liabilities.

**Characteristics of SBA's Leverage Guarantee**

Section 303(b) of the Act authorizes SBA to guarantee the timely payment of all principal and interest as scheduled on Debentures or Participating Securities, pursuant to regulations issued by the Agency. In the final rule published January 31, 1996 (61 FR 3177), the section of the regulations which implemented this provision of the Act was dropped inadvertently. Proposed § 107.1720 would restore the previous language setting forth the unconditional nature and other characteristics of SBA's guarantee.

**Capital Impairment**

SBA is not proposing any substantive changes in the Capital Impairment computations set forth in §§ 107.1830 through 107.1850, but is proposing one clarification. Current § 107.1830(a) has caused some confusion by stating that the current Capital Impairment regulations apply to a Licensee if it has outstanding Leverage issued on or after April 25, 1994. While this statement is true, it is incomplete. This is because SBA Leverage is subject to the Capital Impairment regulations in effect on the date the Leverage is issued. Thus, a Licensee must comply with the current impairment rules if it has Leverage issued on or after April 25, 1994; however, if it has Leverage issued before that date as well, it must also comply with the impairment rules in effect when such Leverage was issued. Proposed § 107.1830(a) would clarify this point by specifically linking the applicability of the Capital Impairment regulations to the Leverage issued. In the same paragraph, the proposed rule would also state that a Licensee must comply with any specific conditions to which it has agreed by contract with SBA. This is not a substantive change, but simply makes explicit a Licensee's obligation to abide by the terms of any agreement it has made with the Agency.

**Miscellaneous Corrections and Editorial Changes**

The definition of ''Commitment'' in § 107.50 would be reworded in the third person (i.e., to refer to ''a Licensee'' instead of ''you'') to conform to the style in which the other definitions are written.

In current § 107.720(c), the SIC code for Operative Builders is incorrect. The proposed rule contains the correct 4-digit code (1531).

Proposed § 107.1590 sets forth special rules applicable to Participating Securities issuers licensed on or before March 31, 1993. The proposed rule would eliminate the current paragraph (c), which allows Licensees to repay outstanding Debentures with the proceeds of newly issued Participating Securities, subject to certain conditions. Since this paragraph properly applies to all Licensees, regardless of licensing date, its content would be transferred to the new proposed § 107.1585. The substance of § 107.1590 would remain unchanged.

In § 107.1600, references to section 321 of the Act would be changed to section 319, reflecting the amendment of the Act by Public Law 104–208.

In the definition of Trust Certificate Rate and in §§ 107.1240 and 107.1520(a)(1), certain technical changes have been proposed to facilitate the interim Leverage funding mechanism currently under consideration by SBA.

**Limited Liability Companies**

Section 208(b)(1) of Public Law 104–208 amended the Act to permit SBICs to organize as limited liability companies (LLCs). SBA is studying the legal and administrative issues which may arise in connection with LLCs, and will publish a proposed rule to implement this form of organization by SBICs at a later date.

Although SBA regulations do not yet provide for LLC Licensees, SBA has the statutory authority to license such companies. SBA's current policy is to accept a license application from an LLC only if the LLC is organized under Delaware's Limited Liability Company Act and does not intend to issue Participating Securities, which SBA has not yet developed in a form suitable for use by an LLC. SBA may reconsider these limitations as SBA acquires greater familiarity with the LLC form of organization and as a body of case law is created under the various state LLC laws. The adoption of a Uniform LLC Act by a significant number of states also would induce SBA to reexamine its current preference for Delaware law.

Until SBA regulations are revised to accommodate LLC Licensees, such Licensees should understand that SBA regards the members of the LLC to be equivalent to the general partners in a partnership Licensee unless the LLC's operating agreement clearly indicates otherwise. Thus, all members of an LLC Licensee will automatically be considered Control Persons and Associates of the Licensee unless the LLC's operating agreement vests management authority only in certain members of the company.

**Compliance With Executive Orders, 12612, 12778, and 12866, the Regulatory Flexibility Act (5 U.S.C. 601, et seq.), and the Paperwork Reduction Act (44 U.S.C. Ch. 35)**

SBA certifies that this proposed rule would not be a significant regulatory action for purposes of Executive Order 12866 because it would not have an annual effect on the economy of more than $100 million, and that it would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.* The purpose of the proposed rule is to implement provisions of Public Law 104–208 which relate to small business investment companies, and to make certain other changes, primarily technical corrections and clarifications, to the regulations governing SBICs.

For purposes of the Paperwork Reduction Act, 44 U.S.C. Ch. 35, SBA certifies that this proposed rule, if adopted in final form, would contain no new reporting or recordkeeping requirements that have not already been approved by the Office of Management and Budget.

For purposes of Executive Order 12612, SBA certifies that this rule would not have any federalism implications warranting the preparation of a Federalism Assessment.

For purposes of Executive Order 12778, SBA certifies that this rule is drafted, to the extent practicable, in accordance with the standards set forth in Section 2 of that Order.

**List of Subjects in 13 CFR Part 107**

Investment companies, Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

For the reasons set forth above, SBA hereby proposes to amend Part 107 of Title 13 of the Code of Federal Regulations as follows:

## PART 107—SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for part 107 continues to read as follows:

**Authority:** 15 U.S.C. 681 et seq., 683, 687(c), 687b, 687d, 687g and 687m, Pub. L. 104–208.

2. Section 107.50 is proposed to be amended by revising the definitions for

Commitment, Common Control, Preferred Securities, Section 301(d) Licensee, and Trust Certificate Rate, and adding a definition of Charge, to read as follows:

**§ 107.50 Definitions of terms.**

* * * * *

*Charge* means an annual fee on Leverage issued on or after October 1, 1996 (except for Leverage issued pursuant to a commitment made by SBA before October 1, 1996), which is payable to SBA by Licensees, subject to the terms and conditions set forth in 107.1130(d).

* * * * *

*Commitment* means a written agreement between a Licensee and an eligible Small Business that obligates the Licensee to provide Financing (except a guarantee) to that Small Business in a fixed or determinable sum, by a fixed or determinable future date. In this context the term ''agreement'' means that there has been agreement on the principal economic terms of the Financing. The agreement may include reasonable conditions precedent to the Licensee's obligation to fund the commitment, but these conditions must be outside the Licensee's control.

*Common Control* means a condition where two or more Persons, either through ownership, management, contract, or otherwise, are under the Control of one group or Person. Two or more Licensees are presumed to be under Common Control if they are Affiliates of each other by reason of common ownership or common officers, directors, or general partners; or if they are managed or their investments are significantly directed either by a common independent investment advisor or managerial contractor, or by two or more such advisors or contractors that are Affiliates of each other. This presumption may be rebutted by evidence satisfactory to SBA.

* * * * *

*Preferred Securities* means nonvoting preferred stock or nonvoting limited partnership interests issued to SBA prior to October 1, 1996, by a Section 301(d) Licensee. Such securities were issued at par value in the case of preferred stock, or at face value in the case of preferred limited partnership interests.

* * * * *

*Section 301(d) Licensee* means a company licensed prior to October 1, 1996 under section 301(d) of the Act as in effect on the date of licensing, that may provide Assistance only to Disadvantaged Businesses. A Section 301(d) Licensee may be organized as a for-profit corporation, as a non-profit corporation, or as a limited partnership.

* * * * *

*Trust Certificate Rate* means a fixed rate determined by the Secretary of the Treasury at the time Participating Securities or Debentures are pooled, taking into consideration the current average market yield on outstanding marketable obligations of the United States with maturities comparable to the maturities of the Trust Certificates being guaranteed by SBA, adjusted to the nearest one-eighth of one percent.

* * * * *

**§ 107.110 [Removed]**

3. Section 107.110 is proposed to be removed.

4. Section 107.120 is proposed to be revised to read as follows:

**§ 107.120 Special rules for a Section 301(d) Licensee owned by another Licensee.**

A Section 301(d) Licensee which was licensed to operate as the subsidiary of one or more Licensees (participant Licensees) may continue to do so, subject to the following:

(a) Each participant Licensee must continue to own at least 20 percent of the voting securities of the Section 301(d) Licensee.

(b) A participant Licensee must continue to treat its entire capital contribution to the subsidiary as a reduction of its Leverageable Capital. The participant Licensee's remaining Leverageable Capital must be sufficient to support its outstanding Leverage.

(c) A participant Licensee may not transfer its Leverage to a subsidiary Section 301(d) Licensee.

5. In § 107.150, the introductory text of paragraph (a)(1) is proposed to be revised to read as follows:

**§ 107.150 Management and ownership diversity requirement.**

* * * * *

(a) *Requirement one.* * * *

(1) At least 30 percent of your Regulatory Capital and Leverageable Capital must be owned by Persons unrelated to management. To satisfy this requirement, such Persons must not be your Associates (except for their status as your shareholders or limited partners) and must not Control, be Controlled by, or be under Common Control with any of your Associates. You must have as investors at least three such Persons who are not Affiliates of one another and whose investments are significant in both dollar and percentage terms, as determined by SBA. As an alternative, you may substitute one investor who is an acceptable Institutional Investor for the three investors who are otherwise required. For purposes of this paragraph (a)(1), the following Institutional Investors are acceptable:

* * * * *

6. Section 107.210 is proposed to be revised to read as follows:

**§ 107.210 Minimum capital requirements for Licensees.**

(a) *Companies licensed on or after October 1, 1996.* A company licensed on or after October 1, 1996 must have Leverageable Capital of at least $2,500,000 and must meet the applicable minimum Regulatory Capital requirement:

(1) *Licensees other than Participating Securities issuers.* A Licensee that does not wish to be eligible to apply for Participating Securities must have Regulatory Capital of at least $5,000,000. As an exception to this general rule, SBA in its sole discretion and based on a showing of special circumstances and good cause may license an applicant with Regulatory Capital of at least $3,000,000, but only if the applicant:

(i) Has satisfied all licensing standards and requirements except the minimum capital requirement, as determined solely by SBA;

(ii) Has a viable business plan reasonably projecting profitable operations; and

(iii) Has a reasonable timetable for achieving Regulatory Capital of at least $5,000,000.

(2) *Participating Securities issuers.* A Licensee that wishes to be eligible to apply for Participating Securities must have Regulatory Capital of at least $10,000,000, unless it demonstrates to SBA's satisfaction that it can be financially viable over the long term with a lower amount. Under no circumstances can the Licensee have Regulatory Capital of less than $5,000,000.

(b) *Companies licensed before October 1, 1996.* A company licensed before October 1, 1996 must meet the minimum capital requirements applicable to such company, as required by the regulations in effect on September 30, 1996. See § 107.1120(c)(2) for Leverage eligibility requirements.

**§ 107.220 [Removed]**

7. Section 107.220 is proposed to be removed.

8. Section 107.230 is proposed to be amended by revising the introductory

text of paragraph (d)(4) to read as follows:

**§ 107.230 Permitted sources of Private Capital for Licensees.**

* * * * *

(d) *Qualified Non-private Funds.*

* * *

(4) Funds invested in or committed in writing to any Section 301(d) Licensee prior to October 1, 1996, from the following sources: * * *

* * * * *

9. In § 107.503, paragraphs (a), (b) and (e), and the heading and first sentence of paragraph (c), are proposed to be revised to read as follows:

**§ 107.503 Licensee's adoption of an approved valuation policy.**

(a) *Valuation guidelines.* You must prepare, document and report the valuations of your Loans and Investments in accordance with the Valuation Guidelines for SBICs issued by SBA. These guidelines may be obtained from SBA's Investment Division.

(b) *SBA approval of valuation policy.* You must have a written valuation policy approved by SBA for use in determining the value of your Loans and Investments. You must either:

(1) Adopt without change the model valuation policy set forth in section III of the Valuation Guidelines for SBICs; or

(2) Obtain SBA's prior written approval of an alternative valuation policy.

(c) *Responsibility for valuations.* Your board of directors or general partner(s) will be solely responsible for adopting your valuation policy and for using it to prepare valuations of your Loans and Investments for submission to SBA.

* * *

* * * * *

(e) *Review of valuations by independent public accountant.* (1) For valuations performed as of the end of your fiscal year, your independent public accountant must review your valuation procedures and the implementation of such procedures, including adequacy of documentation.

(2) The independent public accountant's report on your audited annual financial statements (SBA Form 468) must include a statement that your valuations were prepared in accordance with your approved valuation policy established in accordance with section 310(d)(2) of the Act.

10. Section 107.660 is proposed to be amended by redesignating paragraph (d) as paragraph (e) and by adding a new paragraph (d) to read as follows:

**§ 107.660 Other items required to be filed by Licensee with SBA.**

* * * * *

(d) *Notification of criminal charges.* If any officer, director, general partner or other Control Person is charged with or convicted of any criminal offense other than a misdemeanor involving a minor motor vehicle violation, you must report the incident to SBA within 5 calendar days. Such report must fully describe the facts which pertain to the incident.

* * * * *

11. Section 107.710 is proposed to be amended by adding a sentence at the end of paragraph (e) and by revising paragraphs (b) and (c) to read as follows:

**§ 107.710 Requirement to finance Smaller Enterprises.**

* * * * *

(b) *Smaller Enterprise Financings.* (1) *General rule.* At the close of each of your fiscal years, at least 20 percent of the total dollar amount of the Financings you extended since April 25, 1994 must have been invested in Smaller Enterprises. If you were licensed after April 25, 1994, the 20 percent requirement applies to the total dollar amount of the Financings you extended since you were licensed plus any pre-licensing investments approved by SBA for inclusion in your Regulatory Capital.

(2) *Phase-in for new Licensees.* At the close of your first full fiscal year after licensing, at least 10 percent of the total dollar amount of the Financings you extended, including any pre-licensing investments approved by SBA for inclusion in your Regulatory Capital, must have been invested in Smaller Enterprises. At the close of each fiscal year thereafter, you must meet the requirement in paragraph (b)(1) of this section.

(c) *Special requirement for certain leveraged Licensees.* (1) This paragraph (c) applies if you were licensed on or before September 30, 1996, and you issued Leverage after that date, and you have Regulatory Capital of:

(i) Less than $10,000,000 if such Leverage was Participating Securities; or

(ii) Less than $5,000,000 if such Leverage was Debentures.

(2) At the close of each of your fiscal years, at least 50 percent of the total dollar amount of the Financings you extended after September 30, 1996 must have been invested in Smaller Enterprises.

* * * * *

(e) *Non-compliance with this section.* * * * However, you will not be eligible for additional Leverage until you reach the required percentage (see § 107.1120 (c) and (d)).

12. In § 107.720, paragraph (b)(2) and the introductory text of paragraph (c)(1) are proposed to be revised to read as follows:

**§ 107.720 Small Businesses that may be ineligible for Financing.**

* * * * *

(b) *Passive businesses.* * * *

(2) *Exception for pass-through of proceeds to subsidiary.* You may finance a passive business if it is a Small Business and it passes substantially all the proceeds through to one or more subsidiary companies, each of which is an eligible Small Business that is not passive. For the purpose of this paragraph (b)(2), ''subsidiary company'' means a company in which at least 50 percent of the outstanding voting securities are owned by the Financed passive business.

(c) *Real estate businesses.* (1) You are not permitted to finance any business classified under Major Group 65 (Real Estate) or Industry No. 1531 (Operative Builders) of the SIC Manual, with the following exceptions: * * *

* * * * *

13. In § 107.730, paragraph (d)(3)(iv) is proposed to be revised to read as follows:

**§ 107.730 Financings which constitute conflicts of interest.**

* * * * *

(d) *Financings with Associates.* * * *

(3) *Exceptions to paragraphs (d)(1) and (d)(2) of this section.* * * *

(iv) Both you and your Associate are non-leveraged Licensees, or you are a non-leveraged Licensee and your Associate is not a Licensee.

* * * * *

14. In § 107.740, paragraph (a) is proposed to be revised to read as follows:

**§ 107.740 Portfolio diversification (''overline'' limitation).**

(a) *General rule.* This § 107.740 applies if you have outstanding Leverage or want to be eligible for Leverage. Without SBA's prior written approval, you may provide Financing or a Commitment to a Small Business only if the resulting amount of your aggregate outstanding Financings and Commitments to such Small Business and its Affiliates does not exceed:

(1) 20 percent of your Regulatory Capital as of the date of the Financing or Commitment if you are a Section 301(c) Licensee; or

(2) 30 percent of your Regulatory Capital as of the date of the Financing or Commitment if you are a Section 301(d) Licensee.

* * * * *

15. Section 107.855 is proposed to be amended by revising paragraphs (c)(1), (c)(4)(i) and (d)(4), redesignating paragraphs (g)(1) through (g)(10) as paragraphs (g)(2) through (g)(11), and adding a new paragraph (g)(1) to read as follows:

**§ 107.855 Interest rate ceiling and limitations on fees charged to Small Businesses (''Cost of Money'')**

* * * * *

(c) *How to determine the Cost of Money ceiling for a Financing.* * * *

(1) Choose a base rate for your Cost of Money computation. The base rate may be either the Debenture Rate currently in effect plus the applicable Charge determined under § 107.1130(d)(1), or your own ''Cost of Capital'' as determined under paragraph (d) of this section.

* * * * *

(4) * * *

(i) The current Debenture Rate plus the applicable Charge determined under § 107.1130(d)(1);

* * * * *

(d) *How to determine your Cost of Capital.* * * *

(4) For all qualified borrowings outstanding at your last fiscal year or fiscal quarter end, determine the aggregate interest expense for the past four fiscal quarters, excluding amortization of loan fees. For the purposes of this paragraph (d)(4):

(i) Interest expense on Debentures includes the 1 percent Charge paid by a Licensee under § 107.1130(d)(1); and

(ii) Section 301(d) Licensees with outstanding subsidized Debentures are presumed to have paid interest at the rate stated on the face of such Debentures, without regard to any subsidy paid by SBA.

* * * * *

(g) *Charges excluded from the Cost of Money.* * * *

(1) Discount on the loan portion of a Debt Security, if such discount exists solely as the result of the allocation of value to detachable stock purchase warrants in accordance with generally accepted accounting principles.

* * * * *

16. In § 107.865, the first sentence of paragraph (c)(2) and paragraph (d)(1) are proposed to be revised to read as follows:

**§ 107.865 Restrictions on Control of a Small Business by a Licensee.**

* * * * *

(c) *Rebuttals to presumption of Control.* * * *

(2) The management of the Small Business can elect at least 40 percent of the board members of a corporation, general partners of a limited partnership, or managers of a limited liability company, as appropriate, and the Investor Group can elect no more than 40 percent. * * *

* * * * *

(d) *Temporary Control permitted.* * * *

(1) Where reasonably necessary for the protection of your existing investment;

* * * * *

17. Section 107.1100 is proposed to be revised to read as follows:

**§ 107.1100 Types of Leverage and application forms.**

(a) *Types of Leverageable available.* You may apply for Leverage from SBA in one or both of the following forms:

(1) The purchase or guarantee of your Debentures.

(2) The purchase or guarantee of your Participating Securities.

(b) *Application forms.* Use SBA Form 1022 to apply for Debentures and SBA Form 1022B to apply for Participating Securities.

(c) *Where to send your application.* Send all Leverage applications to SBA, Investment Division, 409 Third Street, S.W., Washington, DC 20416.

**§ 107.1110 [Removed]**

18. Section 107.1110 is proposed to be removed.

19. Section 107.1120 is proposed to be amended by revising paragraph (c), redesignating paragraphs (d) through (f) as paragraphs (e) through (g), and adding a new paragraph (d) to read as follows:

**§ 107.1120 General eligibility requirements for Leverage.**

* * * * *

(c) Meet the minimum capital requirements of § 107.210, subject to the following additional conditions:

(1) If you were licensed after September 30, 1996 under the exception in § 107.210(a)(1), you will not be eligible for Leverage until you have Regulatory Capital of at least $5,000,000.

(2) If you were licensed on or before September 30, 1996, and have Regulatory Capital of less than $5,000,000 (less than $10,000,000 if you wish to issue Participating Securities):

(i) You must certify in writing that at least 50 percent of the aggregate dollar amount of your Financings extended after September 30, 1996 will be provided to Smaller Enterprises (as defined in § 107.710(a)); and

(ii) You must demonstrate to SBA's satisfaction that the approval of Leverage will not create or contribute to an unreasonable risk of default or loss to the United States government, based on such measurements of profitability and financial viability as SBA deems appropriate.

(d) Certify in writing that you are in compliance with the requirement to finance Smaller Enterprises in § 107.710(b).

* * * * *

20. Section 107.1130 is proposed to be amended by revising the heading and paragraphs (a) through (c), redesignating paragraph (d) as paragraph (e), and adding a new paragraph (d) to read as follows:

**§ 107.1130 Leverage fees and additional charges payable by Licensee.**

(a) *Leverage fee.* You must pay a leverage fee to SBA for each issuance of a Debenture or Participating Security. The fee is 3 percent of the face amount of the Leverage issued.

(b) *Payment of leverage fee.* (1) If you issue a Debenture or Participating Security to repay or redeem existing Leverage, you must pay the leverage fee before SBA will guarantee or purchase the new Leverage security.

(2) If you issue a Debenture or Participating Security that is not used to repay or redeem existing Leverage, SBA will deduct the leverage fee from the proceeds remitted to you, unless you prepaid the fee under § 107.1210.

(c) *Refundability.* The leverage fee is not refundable under any circumstances.

(d) *Additional charge for Leverage.*— (1) *Debentures.* You must pay to SBA a Charge of 1 percent per annum on the outstanding amount of your Debentures issued on or after October 1, 1996, payable under the same terms and conditions as the interest on the Debentures. This Charge does not apply to Debentures issued pursuant to a Leverage commitment obtained from SBA on or before September 30, 1996.

(2) *Participating Securities.* You must pay to SBA a Charge of 1 percent per annum on the outstanding amount of your Participating Securities issued on or after October 1, 1996, payable under the same terms and conditions as the Prioritized Payments on the Participating Securities. This Charge does not apply to Participating Securities issued pursuant to a Leverage commitment obtained from SBA on or before September 30, 1996.

* * * * *

21. Section 107.1160 is proposed to be amended by adding introductory text to read as follows:

**§ 107.1160 Maximum amount of Leverage for a Section 301(d) Licensee.**

This section applies to Leverage issued by a Section 301(d) Licensee on or before September 30, 1996. Effective October 1, 1996, a Section 301(d) Licensee may apply to issue new Leverage, or refinance existing Leverage, only on the same terms permitted under § 107.1150.

* * * * *

22. Section 107.1200 is proposed to be amended by revising paragraphs (c) and (d) to read as follows:

**§ 107.1200 SBA's Leverage commitment to a Licensee—application procedure, amount, and term.**

* * * * *

(c) *Limitations on the amount of a Leverage commitment.* The amount of a Leverage commitment must be a multiple of $5,000.

(d) *Term of Leverage commitment.* SBA's Leverage commitment will automatically lapse on the expiration date stated in the commitment letter issued to you by SBA.

23. Section 107.1210 is proposed to be revised to read as follows:

**§ 107.1210 Payment of leverage fee upon receipt of commitment.**

(a) *Prepayment of leverage fee.* As a condition of SBA's Leverage commitment, and before you draw any Leverage, you must prepay the leverage fee established under § 107.1130(a). The fee is equal to 3 percent of the face amount of the Debentures or Participating Securities reserved under the commitment.

(b) *Automatic cancellation of commitment.* Unless you pay the full amount of the leverage fee by 5 P.M. Eastern Time on the 30th calendar day following the issuance of SBA's Leverage commitment, the commitment will be automatically canceled.

24. In § 107.1230, paragraphs (a) and (b) are proposed to be revised to read as follows:

**§ 107.1230 Draw-downs by Licensee under SBA's Leverage commitment.**

(a) *Licensee's authorization of SBA to purchase or guarantee securities.* By submitting a request for a draw against SBA's Leverage commitment, you authorize SBA, or any agent or trustee SBA designates, to guarantee your Debenture or Participating Security and to sell it with SBA's guarantee.

(b) *Limitations on amount of draw.* The amount of a draw must be a multiple of $5,000. SBA, in its discretion, may determine a minimum dollar amount for draws against SBA's Leverage commitments. Any such minimum amounts will be published in Notices in the **Federal Register** from time to time.

* * * * *

25. Section 107.1240 is proposed to be amended by revising paragraphs (a)(1), (b), (c) and (d) to read as follows:

**§ 107.1240 Funding of Licensee's draw request through sale to short-term investor.**

(a) *Licensee's authorization of SBA to arrange sale of securities to short-term investor.* * * *

(1) The sale of your Debenture or Participating Security to a short-term investor at a rate that may be different from the Trust Certificate Rate which will be established at the time of the pooling of your security;

* * * * *

(b) *Sale of Debentures to a short-term investor.* If SBA sells your Debenture to a short-term investor:

(1) The sale price will be the face amount.

(2) At the next scheduled date for the sale of Debenture Trust Certificates, whether or not the sale actually occurs, you must pay interest to the short-term investor for the short-term period. If the actual sale of Trust Certificates takes place after the scheduled date, you must pay the short-term investor interest from the scheduled sale date to the actual sale date. This additional interest is due on the actual sale date.

(3) Failure to pay the interest constitutes noncompliance with the terms of your Leverage (see § 107.1810).

(c) *Sale of Participating Securities to a short-term investor.* If SBA sells your Participating Security to a short-term investor, the sale price will be the face amount.

(d) *Licensee's right to repurchase its Debentures before pooling.* You may repurchase your Debentures from the short-term investor before they are pooled. To do so, you must:

(1) Give SBA written notice at least 10 days before the cut-off date for the pool in which your Debenture is to be included; and

(2) Pay the face amount of the Debenture, plus interest, to the short-term investor.

26. Subpart I of Part 107 is proposed to be amended by removing the undesignated center heading ''Exchange of Outstanding Debentures for Participating or Preferred Securities—Section 301(d) Licensees'', by redesignating § 107.1350 as § 107.1585, and by revising redesignated § 107.1585 to read as follows:

**§ 107.1585 Exchange of Debentures for Participating Securities.**

You may, in SBA's discretion, retire a Debenture through the issuance of Participating Securities. To do so, you must:

(a) Obtain SBA's approval to issue Participating Securities;

(b) Pay all unpaid accrued interest on the Debenture, plus any applicable prepayment penalties, fees, and other charges;

(c) Have outstanding Equity Capital Investments (at cost) equal to the amount of the Debenture being refinanced; and

(d) Classify all your existing Loans and Investments as Earmarked Assets.

27. In § 107.1400, the heading and introductory text are proposed to be revised to read as follows:

**§ 107.1400 Dividends or partnership distributions on 4 percent Preferred Securities.**

If you issued Preferred Securities to SBA on or after November 21, 1989, you must pay SBA a dividend or partnership distribution of 4 percent per year, from the date you issued Preferred Securities to the date you repay them, both inclusive. The dividend or partnership distribution is:

* * * * *

28. Section 107.1420 is proposed to be revised to read as follows:

**§ 107.1420 Articles requirements for 4 percent Preferred Securities.**

If you have outstanding 4 percent Preferred Securities, your Articles must contain all the provisions in §§ 107.1400 and 107.1410.

**§ 107.1430 [Amended]**

29. Section 107.1430 is proposed to be revised by removing the last sentence.

30. In § 107.1500, paragraphs (b)(1) and (b)(4), the last sentence of paragraph (e), and paragraph (f)(2) are proposed to be revised to read as follows:

**§ 107.1500 General description of Participating Securities.**

* * * * *

(b) *Special eligibility requirements for Participating Securities.* * * *

(1) Minimum capital (see § 107.210).

* * * * *

(4) Equity investing, as set forth in this paragraph (b)(4). If you issue Participating Securities, you must invest an amount equal to the Original Issue Price of such securities solely in Equity Capital Investments, as defined in § 107.50.

* * * * *

(e) *Mandatory redemption of Participating Securities.* * * * You must pay the Redemption Price plus any unpaid Earned Prioritized Payments and any earned Adjustments and earned Charges (see § 107.1520).

(f) *Priority of Participating Securities in liquidation of Licensee.* * * *

(2) Any Earned Prioritized Payments and any earned Adjustments and earned Charges (see § 107.1520); and

* * * * *

31. In § 107.1505, the last sentence of paragraph (a) and paragraph (b) are proposed to be revised to read as follows:

**§ 107.1505 Liquidity requirements for licensees issuing Participating Securities.**

(a) *Definition of Liquidity Impairment.* * * * You are responsible for calculating whether you have a condition of Liquidity Impairment:

(1) As of the close of your fiscal year;

(2) At the time you apply for Leverage, unless SBA permits otherwise; and

(3) At such time as you contemplate making any Distribution.

(b) *Computation of Liquidity Ratio.* Your Liquidity Ratio equals your Total Current Funds Available (A) divided by your Total Current Funds Required (B), as determined in the following table:

CALCULATION OF LIQUIDITY RATIO

| Financial account | Amount reported on SBA Form 468 | Weight | Weighted amount |
|---|---|---|---|
| (1) Cash and invested idle funds | ..... | × 100 | ..... |
| (2) Commitments from investors | ..... | × 1.00 | ..... |
| (3) Current maturities | ..... | × 0.50 | ..... |
| (4) Other current assets | ..... | × 1.00 | ..... |
| (5) Publicly Traded and Marketable Securities | ..... | × 1.00 | ..... |
| (6) Anticipated operating revenue for next 12 months [1] | ..... | × 1.00 | ..... |
| (7) Total Current Funds Available | ..... | | A |
| (8) Current liabilities | ..... | × 1.00 | ..... |
| (9) Commitments to Small Businesses | ..... | × 0.75 | ..... |
| (10) Anticipated operating expense for next 12 months | [1] | × 1.00 | ..... |
| (11) Anticipated interest expense for next 12 months | [1] | × 1.00 | ..... |
| (12) Contingent liabilities (guarantees) | ..... | × 0.25 | ..... |
| (13) Total Current Funds Required | ..... | | B |

[1] As determined by Licensee's management under its business plan.

* * * * *

32. In § 107.1510, the introductory text, the last sentence of paragraph (c) and paragraph (d)(1)(ii) are proposed to be revised to read as follows:

**§ 107.1510 How a Licensee computes Earmarked Profit (Loss).**

Computing your Earmarked Profit (Loss) is the first step in determining your obligations to pay Prioritized Payments, Adjustments and Charges under § 107.1520 and Profit Participation under § 107.1530.

* * * * *

(c) *How to compute your Earmarked Asset Ratio.* * * * Otherwise, compute your Earmarked Asset Ratio using the following formula:

$EAR = (EA)(LI) \times 100$

where:

EAR=Earmarked Asset Ratio

EA=Average Earmarked Assets (at cost) for the fiscal year or interim period

LI=Average Loans and Investments (at cost) for the fiscal year or interim period

(d) *How to compute your Earmarked Profit (Loss) if Earmarked Asset Ratio is 100 percent.* * * *

(1) * * *

(ii) For the purpose of determining Net Income (Loss), leverage fees paid to SBA and partnership syndication costs that you incur must be capitalized and amortized on a straight-line basis over not less than five years.

* * * * *

33. Section 107.1520 is proposed to be revised to read as follows:

**§ 107.1520 How a Licensee computes and allocates Prioritized Payments to SBA.**

This section tells you how to compute Prioritized Payments, Adjustments and Charges on Participating Securities and determine the amounts you must pay. To distribute these amounts, see § 107.1540.

(a) *How to compute Prioritized Payments and Adjustments*—(1) *Prioritized Payments.* For a full fiscal year, the Prioritized Payment on an outstanding Participating Security equals the Redemption Price times the related Trust Certificate Rate. For an interim period, you must prorate the annual Prioritized Payment. If your Participating Security was sold to a short-term investor in accordance with § 107.1240, the Prioritized Payment for the short-term period equals the Redemption Price times the short-term rate.

(2) *Adjustments.* Compute Adjustments using paragraph (f) of this section.

(3) *Charges.* Compute Charges in accordance with § 107.1130(d)(2).

(b) *Licensee's obligation to pay Prioritized Payments, Adjustments and Charges.* You are obligated to pay Prioritized Payments, Adjustments and Charges only if you have profit as determined in paragraph (d) of this section.

(1) Prioritized Payments that you must pay (or have already paid) because you have sufficient profit are ''Earned Prioritized Payments''.

(2) Prioritized Payments that have not become payable because you lack sufficient profit are ''Accumulated Prioritized Payments''. Treat all Prioritized Payments as ''Accumulated'' until they become ''Earned'' under this section.

(3) Adjustments (computed under paragraph (f) of this section) and Charges (computed under § 107.1130(d)(2)) are ''earned'' according to the same criteria applied to Prioritized Payments.

(c) *How to keep track of Prioritized Payments.* You must establish three accounts to record your Accumulated and Earned Prioritized Payments:

(1) *Accumulation Account.* The Accumulation Account is a memorandum account. Its balance represents your Accumulated Prioritized Payments, unearned Adjustments and unearned Charges.

(2) *Distribution Account.* The Distribution Account is a liability account. Its balance represents your unpaid Earned Prioritized Payments, earned Adjustments and earned Charges.

(3) *Earned Payments Account.* The Earned Payments Account is a memorandum account. Each time you add to the Distribution Account balance, add the same amount to the Earned Payments Account. Its balance represents your total (paid and unpaid) Earned Prioritized Payments, earned Adjustments and earned Charges.

(d) *How to determine your profit for Prioritized Payment purposes.* As of the end of each fiscal year and any interim period for which you want to make a Distribution:

(1) Bring the Accumulation Account up to date by adding to it all Prioritized Payments and Charges through the end of the appropriate fiscal period.

(2) Determine whether you have profit for the purposes of this section by doing the following computation:

(i) Cumulative Earmarked Profit (Loss) under § 107.1510(f); minus

(ii) The Earned Payments Account balance; minus

(iii) All Distributions previously made under §§ 107.1550, 107.1560 and 107.1570(a); minus

(iv) Any Profit Participation previously allocated to SBA under § 107.1530, but not yet distributed.

(3) The amount computed in paragraph (d)(2) of this section, if greater than zero, is your profit. If the amount is zero or less, you have no profit.

(4) If you have a profit, continue with paragraph (e) of this section. Otherwise, continue with paragraph (f) of this section.

(e) *Allocating Prioritized Payments to the Distribution Account.* (1) If you have a profit under paragraph (d) of this section, determine the lesser of:

(i) Your profit; or

(ii) The balance in your Accumulation Account.

(2) Subtract the result in paragraph (e)(1) of this section from the Accumulation Account and add it to the Distribution Account and the Earned Payments Account.

(f) *How to compute Adjustments.* You must compute Adjustments as of the end of each fiscal year if you have a balance greater than zero in either your Accumulation Account or your Distribution Account, after giving effect to any Distribution that will be made no later than the second Payment Date following the fiscal year end.

(1) Determine the combined average Accumulation Account and Distribution Account balances for the fiscal year, assuming that Prioritized Payments accumulate on a daily basis without compounding.

(2) Multiply the average balance computed in paragraph (f)(1) of this section by the average of the Trust Certificate Rates for all the Participating Securities poolings during the fiscal year.

(3) Add the amounts computed in this paragraph (f) to your Accumulation Account.

(g) *Licensee's obligation to pay Prioritized Payments after redeeming Participating Securities.* This paragraph (g) applies if you have redeemed all your Participating Securities, but you still hold Earmarked Assets and still have a balance in your Accumulation Account.

(1) You must continue to perform all the procedures in this § 107.1520 as of the end of each fiscal quarter and prior to making any Distribution. You must distribute any Earned Prioritized Payments, earned Adjustments and earned Charges in accordance with § 107.1540.

(2) After you dispose of all your Earmarked Assets and make any required Distributions in accordance with § 107.1540, your obligation to pay any remaining Accumulated Prioritized Payments, unearned Adjustments and unearned Charges will be extinguished.

34. Section 107.1530 is proposed to be amended by removing paragraphs (e)(3) and (e)(4) and revising paragraphs (c), (e)(2) and (h) to read as follows:

**§ 107.1530 How a Licensee computes SBA's Profit Participation.**

* * * * *

(c) *How to compute the Base.* As of the end of each fiscal year and any year-to-date interim period for which you want to make a Distribution, compute your Base using the following formula:

$$B = EP - PPA - UL$$

where:

B=Base

EP=Earmarked Profit (Loss) for the period from § 107.1510

PPA=Prioritized Payments for the period from § 107.1520(a)(1), Adjustments (if applicable) from § 107.1520(f), and Charges (if applicable) from § 107.1130(d)(2)

UL=''Unused Loss'' from prior periods as determined in this paragraph (c).

(1) If the Base computed as of the end of your previous fiscal year (your ''Previous Base'') was less than zero, your Unused Loss equals your Previous Base.

(2) If your Previous Base was zero or greater, your Unused Loss equals zero, with the following exception: If you made an interim Distribution of Profit Participation during your previous fiscal year, and your Previous Base was lower than the interim Base on which your Distribution was computed, then your Unused Loss equals the difference between the interim Base and the Previous Base. For example, assume you are computing your Base as of December 31, 1997, your fiscal year end. Your Previous Base, computed as of December 31, 1996, was $3,000,000. During 1996, you made an interim Distribution which was computed on a Base of $3,500,000 as of June 30, 1996. The $500,000 difference between the 1996 interim and year-end Bases would be carried forward as Unused Loss in the computation of your Base as of December 31, 1997.

(3) If you had no Participating Securities outstanding as of the end of your last fiscal year, you may request SBA's approval to treat your Undistributed Net Realized Loss, as reported on SBA Form 468 for that year, as Unused Loss. If you did not file SBA Form 468 because you were not yet licensed as of the end of your last fiscal year, you may request SBA's approval to treat pre-licensing losses as Unused Loss.

* * * * *

(e) *Compute the ''PLC ratio''.* * * *

(2) *Exception.* You may reduce the ratio computed under paragraph (e)(1) of this section if you have increased your Leverageable Capital above its highest previous level. The increase must have taken place at least 120 days before the date as of which your Base is computed. In addition, the increase must have been expressly provided for in a plan of operations submitted to and approved by SBA in writing, or must be the result of the takedown of commitments or the conversion of non-cash assets that were included in your Private Capital. If these conditions are satisfied, compute your reduced PLC ratio as follows:

(i) Divide the highest dollar amount of Participating Securities you have ever had outstanding by your increased Leverageable Capital.

(ii) If the result in paragraph (e)(2)(i) is lower than your PLC ratio currently in effect, such result will become your new PLC ratio.

* * * * *

(h) *Computing SBA's Profit Participation.* If the Base from paragraph (c) of this section is greater than zero, you must compute SBA's Profit Participation as follows:

(1) Multiply the Base from paragraph (c) by the Profit Participation Rate from paragraph (g).

(2) If your last Profit Participation computation was for an interim period during the same fiscal year and used a higher Profit Participation Rate than the

Rate you just used in paragraph (h)(1) of this section, you must adjust the amount computed in paragraph (h)(1) as follows:

(i) Determine the difference between the Profit Participation Rate you just used in paragraph (h)(1) and the Rate used in your previous computation;

(ii) Multiply the difference by the Base from your last Profit Participation computation; and

(iii) Add the result to the amount you computed in paragraph (h)(1).

(3) Reduce the Profit Participation computed in paragraphs (h)(1) and (h)(2) by any amounts of Profit Participation that you distributed or reserved for distribution to SBA, or its designated agent or Trustee, for any previous interim period(s) during the fiscal year. The result is SBA's Profit Participation (unless it is less than zero, in which case SBA's Profit Participation is zero).

* * * * *

35. Section 107.1540 is proposed to be amended by adding a sentence at the end of the introductory text to read as follows:

**§ 107.1540 Distributions by Licensee—Prioritized Payment and Adjustments.**

* * * You must notify SBA of any planned distribution under this section 10 business days before the distribution date, unless SBA permits otherwise.

* * * * *

36. Section 107.1550 is proposed to be amended by adding a sentence at the end of the introductory text and by revising paragraphs (a)(1) and (b) to read as follows:

**§ 107.1550 Distributions by Licensee—permitted ''tax Distributions'' to private investors and SBA.**

* * * You must notify SBA of any planned distribution under this section 10 business days before the distribution date, unless SBA permits otherwise.

(a) *Conditions for making a tax Distribution.* * * *

(1) You have paid all your Prioritized Payments, Adjustments, and Charges, so that the balance in both your Distribution Account and your Accumulation Account is zero (see § 107.1520).

* * * * *

(b) *How to compute the Maximum Tax Liability.* (1) Compute your Maximum Tax Liability for a full fiscal year only. Use the following formula:

$M=(TOI \times HRO) + (TCG \times HRC)$

where:

M=Maximum Tax Liability

TOI=Net ordinary income allocated to your partners or other owners for Federal income tax purposes for the fiscal year immediately preceding the Distribution, excluding Prioritized Payments allocated to SBA

HRO=The highest combined marginal Federal and State income tax rate for corporations or individuals on ordinary income, determined in accordance with paragraphs (b)(2) through (b)(4) of this section

TCG=Net capital gains allocated to your partners or other owners for Federal income tax purposes for the fiscal year immediately preceding the Distribution, excluding Prioritized Payments allocated to SBA

HRC=The highest combined marginal Federal and State income tax rate for corporations or individuals on capital gains, determined in accordance with paragraphs (b)(2) through (b)(4) of this section.

(2) You may compute the highest combined marginal Federal and State income tax rate on ordinary income and capital gains using either individual or corporate rates. However, you must apply the same type of rate, either individual or corporate, to both ordinary income and capital gains.

(3) In determining the combined Federal and State income tax rate, you must assume that State income taxes are deductible from Federal income taxes. For example, if the Federal tax rate was 35 percent and the State tax rate was 5 percent, the combined tax rate would be $[35\% \times (1-.05)]+5\% = 38.25\%$.

(4) For purposes of this paragraph (b), the ''State income tax'' is that of the State where your principal place of business is located, and does not include any local income taxes.

* * * * *

37. In § 107.1560, in the first column of the table in paragraph (e), the column heading is proposed to be revised to read ''If your ratio of Leverage to Leverageable Capital as of the fiscal period end is:'', a sentence is proposed to be added at the end of the introductory text, and paragraphs (a)(1), (a)(4) and (b) are proposed to be revised to read as follows:

**§ 107.1560 Distributions by Licensee—required Distributions to private investors and SBA.**

* * * You must notify SBA of any planned distribution under this section 10 business days before the distribution date, unless SBA permits otherwise.

(a) *Conditions for making distributions.* * * *

(1) You must have paid all Prioritized Payments, Adjustments and Charges, so that the balance in both your Distribution Account and your Accumulation Account is zero (see §§ 107.1520 and 107.1540).

* * * * *

(4) The amount you distribute under this section must not exceed your remaining Retained Earnings Available for Distribution.

(b) *Total amount you must distribute.* Unless SBA permits otherwise, the total amount you must distribute equals the result (if greater than zero) of the following computation:

(1) Your Retained Earnings Available for Distribution as of the end of your fiscal year, after giving effect to any Distribution under §§ 107.1540 and 107.1550; minus

(2) All previous Distributions under this § 107.1560 and § 107.1570(a) that were applied as redemptions or repayments of Leverage; plus

(3) All previous Distributions under § 107.1570(b) that reduced your Retained Earnings Available for Distribution.

* * * * *

38. Section 107.1570 is proposed to be amended by adding a sentence at the end of the introductory text and by revising the heading and paragraphs (b)(1)(i) and (b)(1)(ii) to read as follows:

**§ 107.1570 Distributions by Licensee—optional Distributions to private investors and SBA.**

* * * You must notify SBA of any planned distribution under this section 10 business days before the distribution date, unless SBA permits otherwise.

* * * * *

(b) *Other optional Distributions.* * * *

(1) *Conditions for making a Distribution.* * * *

(i) You have distributed all Earned Prioritized Payments, earned Adjustments, and earned Charges, so that the balance in your Distribution Account is zero (see § 107.1520).

(ii) You have distributed all Profit Participation computed under § 107.1530 which you are required to distribute under § 107.1560 or permitted to distribute under § 107.1570(a), as appropriate, and you have made all required Distributions under § 107.1560.

* * * * *

39. Section 107.1575 is proposed to be added to subpart I to read as follows:

**§ 107.1575 Distributions on other than Payment Dates.**

(a) *Permitted distributions on other than payment dates.* Notwithstanding any provisions to the contrary in §§ 107.1540 through 107.1570, you may make Distributions on dates other than Payment Dates as follows:

(1) Required annual Distributions under §§ 107.1540(a)(1), and any Distributions under §§ 107.1550 and 107.1560, must be made no later than the second Payment Date following the end of your fiscal year;

(2) Required Distributions under § 107.1540(b) must be made no later than the first Payment Date following the end of the applicable fiscal quarter;

(3) Optional Distributions under § 107.1540(a)(2) and § 107.1570 may be made on any date.

(b) *Conditions for making distribution.* All Distributions under this § 107.1575 are subject to the following conditions:

(1) You must obtain SBA's written approval before the distribution date;

(2) You must use the distribution date as the ending date of the period for which you compute your Earmarked Profits, Prioritized Payments, Adjustments, Charges, Profit Participation, Retained Earnings Available for Distributions, liquidity ratio, Capital Impairment, and any other applicable computations required under §§ 107.1500 through 107.1570;

(3) If your Distribution includes an amount which SBA will apply as a redemption of Participating Securities, the effective date of such redemption, for all purposes including future computations of Prioritized Payments, will be the next Payment Date following the distribution date.

40. In § 107.1580, the introductory text of paragraph (a) is proposed to be revised to read as follows:

**§ 107.1580 Special rules for In-Kind Distributions by Licensees.**

(a) *In-Kind distributions.* A Distribution under §§ 107.1540, 107.1560 or 107.1570 may consist of securities (an ''In-Kind Distribution''). Such a Distribution must satisfy the conditions in this paragraph (a).

* * * * *

41. Section 107.1590 is proposed to be amended by removing paragraph (c), redesignating paragraph (d) as paragraph (c), and revising paragraph (a)(1) to read as follows:

**§ 107.1590 Special rules for companies licensed on or before March 31, 1993.**

* * * * *

(a) *Election to exclude pre-existing portfolio.* * * *

(1) The proceeds of your first issuance of Participating Securities are not used to refinance outstanding Debentures (see § 107.1585(a)). SBA will consider payment or prepayment of any outstanding Debenture to be a refinancing unless you demonstrate to SBA's satisfaction that you can pay the Debenture principal without relying on the proceeds of the Participating Securities.

* * * * *

42. In § 107.1600, the first sentence of paragraph (a) and paragraph (b) are proposed to be revised to read as follows:

**§ 107.1600 SBA authority to issue and guarantee Trust Certificates.**

(a) *Authorization.* Sections 319 (a) and (b) of the Act authorize SBA or its CRA to issue TCs, and SBA to guarantee the timely payment of the principal and interest thereon. * * *

(b) *Periodic exercise of authority.* SBA will issue guarantees of Debentures and Participating Securities under section 303 and of TCs under section 319 of the Act at three month intervals, or at shorter intervals, taking into account the amount and number of such guarantees or TCs.

* * * * *

43. Section 107.1720 is proposed to be added to subpart I to read as follows:

**§ 107.1720 Characteristics of SBA's guarantee.**

If SBA agrees to guarantee a Licensee's Debentures or Participating Securities, such guarantee will be unconditional, irrespective of the validity, regularity or enforceability of the Debentures or Participating Securities or any other circumstances which might constitute a legal or equitable discharge or defense of a guarantor. Pursuant to its guarantee, SBA will make timely payments of principal and interest on the Debentures or the Redemption Price of and Prioritized Payments on the Participating Securities.

44. In § 107.1820, paragraph (e)(9) is proposed to be revised to read as follows:

**§ 107.1820 Conditions affecting issuers of Preferred Securities and/or Participating Securities.**

* * * * *

(e) *Restricted Operations Conditions.* * * *

(9) *Failure to meet investment requirements.* You fail to make the amount of Equity Capital Investments required for Participating Securities (§ 107.1500(b)(4)), if applicable to you; or you fail to maintain as of the end of each fiscal year the investment ratios or amounts required for Leverage in excess of 300 percent of Leverageable Capital (§ 107.1160 (c)) or Preferred Securities in excess of 100 percent of Leverageable Capital (§ 107.1160(d)), if applicable to you. In determining whether you have met the maintenance requirements in § 107.1160(c) or (d), SBA will disregard any prepayment, sale, or disposition of Venture Capital Financings, any increase in Leverageable Capital, and any receipt of additional Leverage, within 120 days prior to the end of your fiscal year.

* * * * *

45. In § 107.1830, paragraph (a) is revised to read as follows:

**§ 107.1830 Licensee's Capital Impairment—definition and general requirements.**

(a) *Applicability of this section.* This § 107.1830 applies to Leverage issued on or after April 25, 1994. For Leverage issued before April 25, 1994, you must comply with paragraphs (e) and (f) of this section and the Capital Impairment regulations in this part in effect when you issued your Leverage. For all Leverage issued, you must also comply with any contractual provisions to which you have agreed.

* * * * *

Dated: September 25, 1997.

**Aida Alvarez,**

*Administrator.*

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## DEPARTMENT OF TRANSPORTATION

## Federal Aviation Administration

## 14 CFR Part 39

**[Docket No. 97–NM–77–AD]**

**RIN 2120–AA64**

## Airworthiness Directives; Airbus Model A310 Series Airplanes

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** This document proposes the supersedure of an existing airworthiness directive (AD), applicable to all Airbus Model A310 series airplanes, that currently requires measurement of the force required to move the interior control handle of the emergency exit doors, and various follow-on corrective actions, if necessary. This action would add repetitive functional tests to measure the force necessary to move the interior control handle of the emergency exit doors; and adjusting an emergency exit door or replacing the bearing of the door lifting mechanism, if necessary. This proposal is prompted by reports of seizure of a bearing and increased door handle forces that were outside the limits of the required hand forces due to