

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## SMALL BUSINESS ADMINISTRATION

### 13 CFR Parts 108, 116, 120, 122, 131

#### Business Loan Programs

**AGENCY:** Small Business Administration (SBA).

**ACTION:** Proposed rule.

**SUMMARY:** In response to President Clinton's government-wide regulatory review directive, SBA has completed a page-by-page and line-by-line review of all of its existing regulations. SBA determined that it could eliminate some regulations and consolidate, clarify, and simplify the remainder. This proposed rule consolidates five current CFR parts into one Part to be known as Part 120. The surviving Part 120 covers virtually all policies and regulations, other than size standards, applicable to SBA's business (non-disaster) loan programs. Almost all provisions have been reworded, renumbered, and relocated. There are a few new or revised policies. Several sections have been deleted. However, most of the revisions merely streamline and clarify the regulations and do not represent substantive change.

**DATES:** Comments must be submitted on or before January 16, 1996.

**ADDRESSES:** Address written comments to David R. Kohler, Associate General Counsel for General Law, (120) Small Business Administration, 409 3rd Street S.W., Washington, D.C. 20416.

**FOR FURTHER INFORMATION CONTACT:** Ronald Matzner, Associate Deputy General Counsel; Office of General Counsel, at (202) 205-6882.

**SUPPLEMENTARY INFORMATION:** On March 4, 1995, President Clinton directed all federal agencies to conduct a page-by-page, line-by-line review of their existing regulations to determine which could be eliminated or streamlined. The President's directive complemented SBA's ongoing reinvention effort, which had already targeted portions of the business loan programs for streamlining and simplification. From its review of

its business loan programs, SBA is proposing to eliminate many pages of business loan regulations and consolidate and simplify the remainder.

The proposed rule combines Parts 108, 116, 120, 122 and 131 of 13 CFR into one new Part to be known as Part 120. The new Part 120 will regulate all of SBA's non-disaster financial assistance to small businesses under its general business loan program ("7(a) loans"), its microloan demonstration program ("Microloans"), and its development company program ("504 loans").

Many repetitive and overlapping sections from the current regulations will be eliminated. The remaining provisions will be easy to find and easy to understand. Formerly, provisions applicable to a business loan program were often located in different Parts. Sometimes unintended differences developed between the loan programs in the interpretation or implementation of similar program policies because of minor inconsistencies in the language of the provisions in the several Parts. These inconsistencies have been eliminated.

In the proposed rule, the basic requirements that apply to all of the business loan programs are located in subpart A. These include elements currently found in portions of Parts 108, 116, and 120. Policies specific to a particular program are in the separate subpart applying to that program. Rules specific to 7(a) loans will be in subpart B and include elements currently in portions of Parts 116, 120, and 122. Regulations applying to SBA's special purpose loans currently in Part 122 and a portion of Part 116 will be in subpart C. Subparts D, E, and F will contain rules regarding lenders, program administration, and the secondary market currently found primarily in Part 120. The loan moratorium provisions presently in Part 131 will also be in subpart E. Subpart G will contain rules specific to Microloans currently in Part 122. Finally, regulations applying only to 504 loans currently located in Part 108 will be in subpart H. The following chart summarizes the proposed rule:

Subpart	Subject matter covered	Section numbers
Introduction ...	Overview of Part 120; definitions.	120.1 to 120.99.

Subpart	Subject matter covered	Section numbers
A .....	Policies applicable to all business loans.	120.100 to 120.199.
B .....	Loanmaking policy specific to Guarantees and Direct 7(a) Loans.	120.200 to 120.299.
C .....	Special Purpose Loans.	120.300 to 120.399.
D .....	Lenders .....	120.400 to 120.499.
E .....	Loan Administration.	120.500 to 120.599.
F .....	Secondary Market.	120.600 to 120.699.
G .....	Microloan Demonstration Program.	120.700 to 120.799.
H .....	Development Company Loan Program (504).	120.800 to 120.899.

The most noticeable change in the proposed regulation is in the format. The rule is written in a "user-friendly", "plain-language" style. Provisions have been grouped in logical sequences. Descriptive headings make it easier to find sections. Hyphenated section numbers are no longer used. Questions and answers are sometimes used. Wherever possible, ordinary language is used instead of "government-speak".

SBA's intent was to write regulations that provide easy-to-comprehend notice of the general content of a policy, rather than detailed information explaining or expounding upon that policy. Much explanatory material currently in the regulations and used primarily by SBA personnel to implement SBA's programs has been eliminated from the proposed rule, but is available to the public and may be found in SBA policy guidances, Standard Operating Procedures ("SOPs"), and other SBA materials.

Most of the revisions do not represent policy changes. In many cases, the wording of the regulation has been changed to conform to actual conduct. Although SBA is not aware of any instances, SBA requests comments regarding any inadvertent substantive changes which may have been caused by rewording and format changes.

There are a few substantial policy changes in the proposed rule, however. For example, the "alter ego" rule has been completely revised making more Passive Companies eligible for financial assistance, and new provisions are being proposed allowing Certified Development Companies ("CDCs") to expand into other areas not being

adequately serviced by the existing CDCs in those areas. These and other substantive policies are explained in detail below in the section by section analysis.

Comments to this proposed rule are invited, including suggestions for further clarification and streamlining.

Send them to the person and address noted above, within the time specified.

Each subpart is addressed separately below. Conversion tables are provided detailing all deletions, consolidations, relocations, and policy changes. Immediately below is a chart showing the location of surviving material by Parts.

Former part #	Subject matter	New 120 subpart	New section number(s)
108	Development Company Loans	H	120.800-899
116	Subpart A—Veterans	N/A	120.104
116	Subpart B—Flood Insurance	N/A	120.170
116	Subpart C—Lead-based Paint	N/A	120.173
116	Subpart D—Floodplain Management and Woodlands Protection.	N/A	120.172
116	Subpart E—Coastal Barrier Resources Act	N/A	120.175
120	Subpart—General; Subpart A—Loan-Making Policy	Dispersed in Intro., Subpart A, Subpart B.	120.1
120	Subpart B—Loan Administration	Subpart E	120.500-599
120	Subpart C—Loan Participants	Subpart D	
120	Subpart D	Subpart D	
120	Subpart E	Subpart D	
120	Subpart F	Subpart F	
120	Subpart G	Subpart F	
122	Subpart A—General Provisions	Dispersed in Introduction, Subpart A, Subpart B	
122	Subpart B—Special Purpose Loans	Subpart C	
131	Loan Moratorium	Subpart E	120.532-536

Definitions applicable to all business loans are located in § 120.10, combining separate definitions previously in Parts 108 and 120. Nearly all have been reworded. Some definitions have been added, and some have been eliminated because they were redundant or were incorporated into the text. Of particular note is the definition of "Associate," which was broadened. Conversely, the definition of "close relative" was

limited to the closest family relationship. The net effect of the changes is to pinpoint more effectively the individuals subject to the ethical requirements and conflict of interest prohibitions of the regulations. Terms which are defined in the proposed rule are capitalized in this preamble for consistency. In addition, references to SBA Regional offices and officers have been eliminated and usually, but not

always, replaced with a reference to District Director because of SBA's recent restructuring.

A detailed listing of changes specific to each subpart follows.

120 Subpart A and B—General Loan Policy and Guaranteed and Direct 7(a) Loans

The following is a conversion table for Subparts A and B:

Former section number	New part 120 number for loan provisions	Action(s) (Note: all sections were renumbered and moved, or deleted)	Extent of policy change, if any; comments on action(s)
116.1-116.3	120.104	Revised; Subpart was split; provisions moved to program Parts.	Minor policy change; explanatory material and definitions will be in SOP or other policy material.
116.10-116.12	120.170	Revised; provisions condensed	No policy change; explanatory material will be in SOP or other policy material.
116.20-116.23	120.173	Revised; provisions condensed	No policy change; explanatory material will be in SOP or other policy material.
116.30-116.35	120.172	Revised; provisions condensed	No policy change; explanatory material will be in SOP or other policy material.
116.40-116.41	120.175	Revised; provisions condensed	No policy change.
116 Appendix A	N/A	Deleted	No policy change. Material no longer needed.
116 Appendix B	N/A	Deleted	No policy change. Material no longer needed.
120.1-1	120.1	Revised; some deletion; material moved	No policy change. Some explanatory material no longer valid.
120.1-2	120.4	Revised	No policy change.
120.1-3	120.180	Revised	No policy change.
120.1-4	N/A	Deleted. Unnecessary	No policy change.
120.2	120.10	Rewritten	No policy change. New definitions are added; an owner is now considered an "Associate."
120.2-1	120.1	Rewritten	No policy change.
120.2-2	120.10	Revised	See Policy Note above.
120.2-3	N/A	Deleted	No policy change. Definition will no longer be used.

Former section number	New part 120 number for loan provisions	Action(s) (Note: all sections were renumbered and moved, or deleted)	Extent of policy change, if any; comments on action(s)
120.2-4	120.10	Revised	Minor policy change. This definition has been dropped, but sub-definitions were modified and included elsewhere.
120.2-5	120.10	Revised	Minor policy change. Definition of Lending Institution was dropped.
120.2-6	120.10	Revised	Minor policy change. Both definitions were dropped.
120.2-7	N/A	Deleted	Minor policy change. Definition was dropped, as no longer used.
120.2-8	120.470	Rewritten	No policy change.
120.3-1	120.2	Rewritten	No policy change.
120.3-2	120.2(a)	Rewritten	No policy change.
120.3-3	120.2	Rewritten	No policy change.
120.3-4	120.101	Consolidated with 120.103-1	No policy change.
120.100	N/A	Deleted	No policy change. Section not needed.
120.101-1(a)	120.100(d)	Rewritten	No policy change.
120.101-1(b)	120.103	Rewritten	No policy change.
120.101-1(c)	120.110(j)	Revised	No policy change. Section now combined with another.
120.101-2	120.110	Revised	No policy change.
120.101-2(a)	120.110(k)	Revised	Clarifies policy regarding promotion of religion. See Note 1, below.
120.101-2(b)	120.110(g)	Revised	No policy change. explanatory material will be in SOP or other policy material.
120.101-2(c)	120.110(h)	Revised	No policy change. Needless wording was deleted.
120.101-2(d)	120.110(b)(c), 120.111	Revised; new rule included	Major policy changes. See Note 2, below.
120.101-2(d) (1) through (7).	120.111	Revised; New Rule.	Major policy changes. See Note 2, below.
120.101-2(d)	120.110(g)	Revised	No policy change.
120.101-2(f)	120.110(f)	Rewritten	No policy change.
120.101-2(g)	120.110(m)	Revised	No policy change.
120.102	120.120	Revised	No policy change.
120.102-1	120.130(f), 120.201	Revised	No policy change.
120.102-2	120.207, 120.130(d)	Revised	No policy change.
120.102-3	120.130(a)	Revised	No policy change.
120.102-4	120.104, 120.130(b)	Revised	No policy change.
120.102-4(a)	120.104	Revised	No policy change.
120.102-4(b)	120.104	Revised	No policy change.
120.102-5	120.130(c)	Revised	No policy change.
120.102-6	120.202	Revised	No policy change. Wording changed to reflect agency policy.
120.102-7	120.110(i)	Revised	Minor policy change. See Note 3 below.
120.102-8	120.130, 120.130(e)	Revised	No policy change.
120.102-9	None	Deleted	Minor policy change. Provision was not used.
120.102-10, 120.102-10 (a)-(f).	120.140, 120.110(o)	Revised; new Rule	Major policy change. See Note 4 below.
120.102-11	120.130	Revised	Minor new policy. 180-day parameter added.
120.102-12 (a)-(d)	120.110(q)	Revised	Minor policy change. See Note 5 below.
120.103-1(a), 120.103-1(b).	120.101, 120.102	Rewritten	Major policy change. See Note 6 below.
120.103-2	120.150	Revised	No policy change.
120.103-2(a)	120.150	Revised	No policy change.
120.103-2(b)	120.150(f)	Rewritten	No policy change.
120.103-2(c)	120.160(a), 120.201	Revised	Minor policy change or clarification. See Note 7 below.
120.103-2(d)	120.160(b)	Revised	No policy change.
120.103-2(e)	120.160(c), 120.170	Revised	No policy change. Though not now specifically mentioned in the regulation, life insurance may still be required as part of prudent lending.
120.103-2(f)	120.170, 120.172-73, 120.175-76.	Revised	No policy change.
120.103-2(g)	120.160(d)	Revised	Minor policy change—depository plan no longer required.
120.103-2(h)	120.200	Revised	No policy change.
120.103-3 (a)-(e)	120.193	Revised	No policy change.
120.104-1 (a)-(e)	120.220	Rewritten	No policy change.
120.104-1(f)	N/A	Deleted	Eliminated from statute.
120.104-2(a)(1)	N/A	Deleted	No policy change; policy will now be contained in SOP or other policy guidance.

Former section number	New part 120 number for loan provisions	Action(s) (Note: all sections were renumbered and moved, or deleted)	Extent of policy change, if any; comments on action(s)
120.104-2(a)(2) .....	N/A .....	Deleted .....	Major policy change; deleted from the Act. Provision eliminated by statute (and had never been implemented by SBA).
120.104-2(a)(3) .....	N/A .....	Deleted .....	
120.104-2(b) .....	120.221(e)(f) .....	Rewritten .....	No policy change.
120.104-2(c) .....	120.221(b) .....	Rewritten .....	No policy change.
120.104-2(d) .....	120.222 .....	Revised .....	No policy change.
120.104-2(e)(1) .....	120.222 .....	Revised .....	No policy change.
120.104-2(e)(2) .....	120.221(a) .....	Revised .....	No policy change.
120.104-2(e)(3) .....	120.223(a), 120.222(e), 120.221(d) .....	Revised .....	No policy change.
120.104-2(e)(4) .....	120.222(c) .....	Rewritten .....	No policy change.
120.104-2(f) .....	120.195 .....	Rewritten .....	No policy change—Clarified that does apply to 504 loans. See Note 8.
120.105 .....	120.176 .....	Rewritten; consolidated .....	No policy change. Note that recent regulatory additions appear in 120.171 and 174. More guidance can be found in SOP.
120 Appendix A .....	N/A .....	Deleted .....	No policy change. Terms of the agreement are in effect. Agreement will appear in SOP or other policy material.
122.1 .....	120.1 .....	Combined .....	No policy change.
122.2 .....	N/A .....	Deleted .....	No policy change.
122.3-1 .....	120.180 .....	Consolidated .....	No policy change.
122.3-2 .....	N/A .....	Deleted .....	No policy change.
122.4 .....	120.176 .....	Consolidated .....	No policy change.
122.5-1 .....	120.101 .....	Revised; combined .....	No policy change.
122.5-2 .....	120.191 .....	Revised .....	No policy change.
122.5-3 .....	120.101, 120.190(d) .....	Consolidated; rewritten .....	No policy change.
122.5-4 .....	120.192 .....	Rewritten .....	No policy change.
122.5-5 .....	120.192 (definition.) .....	Revised .....	No policy change.
122.6-1(a)(b) .....	120.212 .....	Revised .....	No policy change.
122.6-2 .....	120.530 .....	Moved; revised .....	No policy change.
122.6-3, Part 131 .....	120.532-535 .....	Moved; combined; revised .....	No policy change.
122.7 .....	120.151 .....	Rewritten .....	No policy change.
122.7-1 .....	120.211(a)(b) .....	Revised .....	No policy change.
122.7-2 .....	120.211(c) .....	Rewritten .....	Reference to District Director's authority to make exceptions will be in SOP.
122.7-3 .....	120.151 .....	Rewritten .....	No policy change.
122.7-3(a) .....	120.210(a) .....	Revised .....	Minor policy change; increase approval will be by AA/FA.
122.7-3(b) .....	120.210(b) .....	Revised .....	No policy change.
122.7-3(c) .....	120.210(c) .....	Revised .....	No policy change.
122.8-1 .....	120.213(b) .....	Revised .....	No policy change.
122.8-2 .....	120.213(b) .....	Revised .....	No policy change.
122.8-3 .....	120.213(a) .....	Revised .....	No policy change.
122.8-4 .....	120.214 .....	Rewritten .....	No policy change.
122.8-4(a) .....	120.214(a) .....	Rewritten .....	No policy change.
122.8-4(b) .....	120.214(a) .....	Rewritten .....	No policy change.
122.8-4(c) .....	120.214(b) .....	Revised .....	Clarifies that movement in amount of loan must equal movement in base rate.
122.8-4(d) .....	120.214(c) .....	Moved .....	No policy change.
122.8-4(e) .....	120.214(d) .....	Moved .....	No policy change.
122.8-4(f) .....	120.214(e) .....	Moved .....	No policy change.
122.8-4(g) .....	120.214(f) .....	Rewritten .....	No policy change.
122.8-4(h) .....	120.214(g) .....	Revised .....	No policy change.

The following chart lists additions to Part 120:

Section number	Subject matter covered
120.110(r)	Prohibition for businesses engaged in political and lobbying activities.
120.110(o)	Prohibition for businesses engaged in pornographic or sexually-oriented (non-medical) activities. See Note 1 below.

Section number	Subject matter covered
120.171 ...	Compliance with Child Support Obligations as a condition of an SBA loan.
120.174 ...	Earthquake hazards notice.
120.190 ...	Where a business applies for a loan.
120.193 ...	Use of computer generated forms.

Note 1. SBA often receives eligibility questions from Borrowers and Lenders. In the

proposed rule, SBA has attempted to delineate clearly and succinctly the businesses that are ineligible for SBA financial assistance. In particular, SBA field offices, loan applicants, Lenders, development corporations and other SBA intermediaries have requested guidance concerning the eligibility of businesses which may be engaged in religious activities. After consulting with the Department of Justice, SBA proposes to provide such guidance through these new regulations. The present regulation states that churches and religious organizations are ineligible for SBA financial assistance. It does not specify

whether the prohibition extends to businesses principally engaged in promoting religion through their activities. Nonetheless, such businesses in the past have been found to be ineligible.

SBA's primary focus is to provide financial assistance to for-profit small businesses that can contribute to job growth and economic development in the United States. Within the limits set by the Establishment Clause of the Constitution, SBA does not disqualify otherwise eligible small businesses from receiving financial assistance merely because they offer religious books, articles, or other products for sale or because they support or encourage moral and ethical values based upon religious beliefs. At the same time, SBA does not make financial assistance available to religious entities or their affiliates for use in directly promoting or teaching religion.

The Establishment Clause of the First Amendment, which states "Congress shall make no law respecting an establishment of religion," serves as a limitation on governmental activities with regard to religion. The Establishment Clause primarily proscribes "sponsorship, financial support, and active involvement of the sovereign in religious activity." *Walz v. Tax Commission*, 397 U.S. 664, 668 (1970). "Neither a state nor the Federal Government \* \* \* can pass laws which aid one religion, aid all religions, or prefer one religion over another \* \* \* No tax in any amount, large or small, can be levied to support any religious activities or institutions, whatever they may be called, or whatever form they may adopt to teach or practice religion." *Everson v. Bd. of Educ.*, 330 U.S. 1, 15-16 (1947); see also *Grand Rapids School Dist. v. Ball*, 473 U.S. 373, 381 (1985) (quoting this language); *McCullum v. Bd. of Educ.*, 333 U.S. 203, 210 (1948) (same).

Under the proposed rule, SBA would not provide financial assistance to businesses principally engaged in teaching, instructing, counseling, or indoctrinating religion or religious beliefs. While incidental or indirect support of religious objectives might be permissible, SBA would not provide financial assistance to a newspaper, broadcasting business, day care center, or private school principally engaged in such activities.

Some of the more difficult eligibility inquiries received by SBA field offices have involved businesses which engage in activities in a secular setting which may be considered to be religious in nature. The U.S. Supreme Court has held that aid used to fund specifically religious activities in an otherwise substantially secular setting, has the primary effect of advancing religion, and therefore violates the Establishment Clause. *Hunt v. McNair*, 413 U.S. 734 (1973); *Bowen v. Kendrick*, 487 U.S. 589, 613 (1988). The facts of each situation must be carefully examined. With the above Supreme Court standard in mind, SBA proposes to include among ineligible businesses those principally engaged in teaching, instructing, counseling or indoctrinating religion or religious beliefs, whether the setting is religious or secular, because, in SBA's view, financial assistance to such small businesses would violate the Establishment Clause.

SBA field office personnel and others also have sought guidance on the eligibility of

small businesses which sell sexually oriented products or services, or engage in sexually oriented activities. The present regulation is silent regarding obscene, pornographic, or sexually oriented activities. A business engaging in any such activity that is illegal is ineligible under § 120.110(h) of this regulation. However, SBA receives inquiries regarding businesses engaged in activities which, while not illegal, may be considered by the average person to be obscene or pornographic.

"Obscene" material is not protected by the First Amendment. It has been defined by the United States Supreme Court in the context of a criminal case, *Miller v. California*, 413 U.S. 15, 24 (1973), as follows: "\* \* \* whether a work which depicts or describes sexual conduct is obscene is [determined by] whether the average person, applying contemporary community standards, would find that the work, taken as a whole, appeals to the prurient interest, whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law, and whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value."

Under Supreme Court precedent, "[w]hen the government appropriates funds to establish a program, it is entitled to define the limits of that program." *Rust v. Sullivan*, 114 L.Ed.2d 233, 256 (1991). In implementing its programs, SBA must also follow the Congressional mandate set forth in Section 4(d) of the Small Business Act (15 U.S.C. 633(d)) ("the Act") to consider the public interest in granting or denying an application for SBA financial assistance.

Having considered the legal precedent and the Congressional mandate, SBA has determined that it may exclude small businesses engaging in lawful activities of an obscene, pornographic, or prurient sexual nature. Under the proposed rule, SBA would not provide financial assistance to small businesses which present live performances of a prurient sexual nature or which derive significant gross revenue from the sale, on a regular basis, of depictions or services, or the presentation of depictions or displays, of a pornographic, obscene, or prurient sexual nature. Thus, an establishment featuring nude dancing, or a book, magazine or video store containing merchandise of a prurient sexual nature would not be eligible for SBA financial assistance if the obscene, pornographic, or prurient activity contributed to the generation of a significant portion of the gross revenue of the business.

SBA considers this proposed rule to be consistent with its obligation to direct its limited resources and financial assistance to small businesses in ways which will best accomplish SBA's mission, serve its constituency, and serve the public interest. Applicants' First Amendment freedoms are in no way abridged. They may still express their views, exercise their freedoms, operate their businesses, and obtain any other aid available to them.

SBA is considering the use of a percentage of gross revenue instead of "significant" in the final formulation of this rule and requests commenters to focus particularly on the relative merits of the two approaches and what percentage would be appropriate.

Note 2. The proposed regulation establishes a new "Eligible Passive Company" rule replacing the current "alter ego" rule. The new rule will be found at § 120.111. An "Eligible Passive Company" is defined as an entity which does not engage in regular and continuous business activity, which leases real or personal property to an Operating Company for use in the Operating Company's operations. SBA generally makes business loans only to small businesses engaged in regular business activities, and prohibits such assistance to entities engaged in passive investment or real estate development, or which do not engage in regular and continuous activity as an operating business. SBA calls such entities "passive businesses." At the same time, SBA recognizes that valid business reasons may exist for an Operating Company not to own the real estate and fixed assets used to conduct its business. This proposed rule would allow certain passive businesses to be eligible for SBA assistance if that assistance is used only to acquire and/or improve real or personal property leased to a small business and is used in that small business' operations. The proposed rule would eliminate certain requirements and restrictions which presently limit the use of real estate holding entities in SBA's business-loan and development company programs.

For purposes of these regulations, an Operating Company is defined in section 120.100 as a small business actively currently involved in conducting business operations or about to be located on real property owned by an Eligible Passive Company, or using or about to use in its business operations, personal property owned by an Eligible Passive Company.

Many years ago, SBA agreed to assist eligible Operating Companies seeking SBA financial assistance through their affiliated "mirror image" passive businesses by creating an exception for such "alter egos". Subsequent modifications to the mirror image requirement permitted variations in ownership percentages between the operating business and the alter ego for immediate family members. Such variances led to conflicting interpretations of the policy, which have frustrated its original intent and confused both the public and SBA personnel. Such variances limited the effectiveness of the intended assistance. In addition, the variances caused inconsistencies between the 7(a) loan program and the development company loan program.

On February 22, 1994, SBA published (59 FR 8425) a proposed rule ("1994 proposal") to eliminate the conflicting interpretations and inconsistencies and to revise the family member common ownership threshold to extend the alter ego exception to additional passive businesses. SBA received more than twenty detailed comments suggesting changes in the proposal. It also has received many other suggestions and recommendations from small business owners, development companies, lending institutions and SBA employees at regulatory partnership meetings and other outreach activities conducted by SBA. After considering these comments and suggestions, SBA has revised its thinking sufficiently to

warrant publication of this new proposed rule, included here as an integral part of SBA's overall regulatory streamlining.

In its 1994 proposal, SBA suggested reducing the common ownership threshold for any passive business and Operating Company to 20 percent. Most of the comments suggested that, as an exception to a "mirror image" requirement, a 20 percent threshold was insufficient to support a nexus between a passive business and an Operating Company. Some suggested that the nexus be increased to 50 percent, others to 80 percent. However, others suggested that SBA eliminate the "mirror image" rule altogether. After carefully considering all of the options, the goals and the objectives of SBA's loan programs, SBA proposes to eliminate the present alter ego rule, and allow such a loan whenever it essentially represents financial assistance to an Operating Company.

Many small businesses utilize separate entities to hold the real estate or leasehold improvements used in the operation of their businesses. SBA now believes that an Eligible Passive Company, without regard to its ownership interests, should be an eligible entity for SBA financial assistance if it only uses such assistance to acquire and/or improve real or personal property which it leases to an Operating Company for the conduct of its operations.

SBA's new proposed "Eligible Passive Company" rule recognizes that an Eligible Passive Company may be an individual, sole proprietorship, corporation, limited liability company, an irrevocable trust or any form of partnership. Under the current rule, trust ownership of any part of an Eligible Passive Company is prohibited in the SBA business loan program. The development company program permits the use of trusts as eligible owners. In this proposed rule (as in its 1994 proposal), SBA proposes to eliminate the inconsistency between the 7(a) loan program and the development company loan program. SBA believes that there is no reason to prohibit a small business concern using the SBA's business loan programs from taking advantage of the tax and planning benefits which may be inherent in the use of an irrevocable trust. Trust eligibility shall be determined by the eligibility status of the trustor (grantor/settlor), with all donors to the trust being presumed conclusively to have trustor status for eligibility purposes.

SBA welcomes comments on whether use of a revocable trust should also be permitted. While this would give Borrowers greater planning flexibility, the trustor's reserved authority to amend the trust might lead to fronts or other abuses. Under this proposed rule, an Operating Company must be an eligible small business under SBA's standards, and the proposed use of proceeds by the Eligible Passive Company would have to be an eligible use if the Operating Company were obtaining the financing directly. This ensures that the Eligible Passive Company will utilize SBA's financial assistance in the same manner as an eligible small business. As suggested by several comments on the 1994 proposal, both the Eligible Passive Company and the Operating Company must meet SBA's size standards (13 CFR Part 121).

In response to other comments on the 1994 proposal, the new rule clarifies that the lease between the Eligible Passive Company and the Operating Company must be subordinated to SBA's security interest, mortgage or trust deed lien and the Eligible Passive Company (as landlord) must pledge as collateral an assignment of rents derived from the lease. The requirement for an assignment of the lease has been eliminated, but an assignment may be required by SBA when necessary to perfect a lien under applicable law.

Several comments urged SBA not to require the Operating Company to be a co-Borrower on a loan to an Eligible Passive Company, suggesting that legitimate tax and business reasons exist in many cases for the Operating Company to be a guarantor instead of a co-Borrower. Believing this to be a credit and business decision best left to the discretion of SBA loan officers, the Borrower, and (in the development company program) the development company, SBA has provided that the Operating Company may be either a guarantor or a co-Borrower in most cases. An exception is created for loans in the 7(a) loan programs in which working capital funding is included, in which case the Operating Company must be a co-Borrower.

When an Operating Company applies for SBA loan assistance, each 20 percent or more ownership interest holder in the Operating Company must guarantee the loan. Since the Operating Company will be a co-Borrower or guarantor when an Eligible Passive Company is the Borrower, the proposed rule would extend the same requirement to ownership interests of both the Operating Company and the Eligible Passive Company.

Several comments noted that it is common for an Operating Company to need working capital when the Eligible Passive Company applies for a loan primarily to finance the acquisition of real or personal property. In the past, SBA has required the Eligible Passive Company to use the loan proceeds solely to acquire and improve property for lease to an Operating Company. Thus, two separate SBA loans would be needed—one to the Eligible Passive Company for the real property and the other to the Operating Company for working capital. The commenters suggested that SBA permit proceeds of a single loan to the Eligible Passive Company to be used for working capital in the Operating Company. This proposed rule adopts these suggestions for the 7(a) loan program, provided that the Operating Company is a co-Borrower. The loan proceeds for working capital would be allocated to the Operating Company, while those for acquisition and improvement of property for lease to the Operating Company would be allocated to the Eligible Passive Business. Under this approach, small businesses would no longer incur duplicate costs and would benefit by reduced paperwork and a streamlined loan process.

Several comments noted that a trust, established to take advantage of tax and planning benefits inherent in the trust form, may have a need to engage in other activities. They argued that SBA should not prohibit a trust which qualifies as an Eligible Passive Company from engaging in activities other

than the leasing of property to the Operating Company. SBA agrees. Accordingly, under this proposed rule, a trust qualifying as an Eligible Passive Company may engage in other activities authorized under its trust documents. The Trustee will need to certify to SBA (and provide pertinent language from the trust document) that the Trustee has authority to act, and that the trust has the authority to borrow funds, pledge trust assets and lease the property to the Operating Company. The Trustee also will need to provide SBA with a list of all trustors and donors.

Note 3. To be eligible for SBA financial assistance, the products and services of a business must be available to the general public. Because the current rule refers only to recreational and amusement enterprises, it is misleading and confusing, and is not uniformly enforced by SBA field offices. The proposed rule clarifies that private clubs and businesses that limit the number of members for reasons other than capacity are ineligible for SBA financial assistance.

Note 4. The current regulations have separate conflict-of-interest sections for Lenders and development companies. SBA has re-written and consolidated the sections. The prohibitions are clear and consistent for all business loan program participants. The proposed rule expands the categories of individuals subject to the requirements and may encompass additional acts not specifically enumerated.

Note 5. The prohibition against assisting a business which previously has caused SBA to sustain a loss is currently stated explicitly only in the 7(a) regulations, although it is applied in all of SBA's business loan programs. Its inclusion in subpart A clarifies that the policy applies to all business loans. Considerable explanatory material currently in the 7(a) regulation has been removed and will be placed in an SOP or other policy guidance.

Note 6. SBA may provide financial assistance only if the applicant shows that the desired credit is needed and not otherwise available on reasonable terms. In § 120.101, SBA clarifies its present policy. The current provision, § 120.103-1 uses the language "not otherwise available on reasonable terms" without indicating any factors which should be considered in determining what is reasonable. Section 3(h) of the Act defines "credit elsewhere" as the availability of credit from non-Federal sources on reasonable terms and conditions taking into consideration the prevailing rates and terms in the community in or near where the concern transacts business, for similar purposes and periods of time. SBA believes the language in section 3(h) clarifies the credit elsewhere test and proposes to include the language in § 120.101. In addition, the current regulation provides that the certification made by a Lender in its application for an SBA guarantee is generally accepted as sufficient documentation that the desired credit is unavailable to the applicant. In the proposed § 120.101, SBA clarifies and reaffirms its existing policy that the Lender or CDC must have examined the availability of credit to the applicant, have based its

certification upon that examination, and have documentation in its file to support the certification.

In the 7(a) program, SBA often required applicant principals and owners to use personal assets before granting financial assistance, unless undue hardship would result. In the 504 program, SBA did not enforce this policy and rarely required applicants to use their own personal resources.

In this proposed rule, SBA clarifies that there is no difference between the business loan programs regarding evidence of need. SBA will consider the personal wealth and resources of the principals and owners in determining an applicant's need for SBA financial assistance in all business loan programs, and SBA may require the principals and owners of the applicant to use their personal resources before SBA will grant financial assistance.

Note 7. Current regulations require owners of 20 percent or more of a business to guarantee an SBA loan. Under SBA's current SOP, SBA may require owners of between 5 and 20 percent of a business to guarantee a loan. Since the public is not always aware of its SOP, SBA is including the latter policy in this proposed rule. Rather than set an arbitrary lower limit of 5 percent (or any other number), SBA proposes that the rule state that SBA may require holders of interests of less than 20 percent of an applicant to guarantee an SBA loan, when appropriate under prudent underwriting criteria.

Note 8. The use of SBA Form 159 (Compensation Agreement) in the 504 program has been a subject of controversy for some time. The Act requires 7(a) applicants to certify the names of and fees paid to all professionals or other representatives engaged by the applicant in connection with the SBA financial assistance. Current section 120.104-2(f) implements the statutory requirement. Title V of the Small Business Investment Act, 15 U.S.C. 695 ("Title V") does not have a corresponding provision. Despite this, SBA, citing section 7(a)(13) of the Act, has generally extended the requirement to the development company program. Current section 108.503-6(e) requires the loan application submitted to SBA by a Certified Development Company (CDC) to disclose the amount of all fees paid, the names of the fee recipients, and a description of the services rendered. Most SBA field offices require in 504 loan authorizations that Form 159 be submitted. Many Lenders in the 7(a) program and CDCs in the 504 Program contend that Form 159 has become a burden upon the Borrowers, the Lenders and the CDCs. The 504 industry, in particular, has asked SBA to eliminate the form.

President Clinton has directed Federal agencies to reduce the paperwork burden upon the public whenever possible. However, this requirement is contained in the Act. Therefore, SBA may not eliminate the regulation with respect to the 7(a) program without a statutory change. Congress has recently held hearings regarding the disclosure of fees because of concern about the increased number of investigations of

fraud by applicant representatives. As a result, SBA believes it is prudent to continue to require full disclosure of all fees. Since SBA sees no reason to differentiate among the various business loan programs regarding this issue, SBA is proposing in this Rule to maintain the requirement for all business loans until such time that Congress revisits the issue.

#### 120 Subpart C—Special Purpose Loans

The proposed new Subpart C reorganizes and consolidates the current subpart B of Part 122, "Special Purpose Loans" with a portion of Part 116.

In §§ 122.51 through 122.51-6, currently known as "Handicapped Assistance Loans," the word "Disabled" replaces the word "Handicapped" wherever it appears. Section 122.60 "Rural Loans" is deleted since this special program expired on September 30, 1995. The section currently beginning at § 122.61, "Microloan Demonstration Project," has been reorganized as subpart G of Part 120 to separate it from 7(a) Special Loan Programs. There are no major substantive changes in the remaining eleven Special Loan Programs. A new revolving credit program—CapLines—replaces the GreenLine program and is outlined in § 120.395.

In the proposed rule, this subpart outlines the significant policies of each program in a streamlined format while deleting superfluous and repetitious material.

#### 120 Subpart D—Lenders

Proposed subpart D reorganizes and consolidates current Part 120 subparts C ("Loan Participants"), D ("Preferred Lenders Program"), and E ("Certified Lenders Program"). Sections have been grouped together to aid the reader in locating information. There are only a few substantive changes in subpart D.

Proposed new § 120.430 states specifically that SBA may review a Lender's records relating to SBA guaranteed loans during normal business hours. In addition, § 120.420, which is the former § 120.301-7, contains a new provision (120.420(c)) restricting the use of SBA loans by Non-Depository Lenders.

(a) Certified Lenders Program ("CLP"). The proposed rule deletes the definitions found now at § 120.501. Some of the terms are not used in the subpart. Others apply to the entire Part and will appear in § 120.10.

The proposed rule streamlines the procedure for obtaining CLP status. Thus, current § 120.502-1 will be deleted and replaced with new § 120.441 authorizing SBA District Directors (whose decision is final) to approve and renew CLP Lenders.

Section 120.441(c) clarifies that CLP status applies only in the SBA office which approved that status.

The proposed rule will eliminate current § 120.502-2, which specifies factors which SBA will consider in deciding whether a Lender should become a CLP lender. Its replacement, § 120.441(a), retains several of the current seven considerations. SBA may consider other factors as well.

Proposed § 120.442, "Suspension or revocation of CLP status" is new, and follows the mechanism and procedure established for PLP lenders.

(b) Preferred Lenders Program ("PLP"). The proposed PLP regulations delete superfluous information and have been reorganized into a more logical sequence. They also will reflect SBA reorganization and program changes, including the establishment of the centralized PLP processing office located in Sacramento, California.

The proposed rule deletes the definitions found now at § 120.401. Some of the terms are not used in the subpart. Others apply to the entire Part and will appear in § 120.10.

Current § 120.402-1 describes how a Lender initially may become a PLP Lender. Proposed § 120.451(a) describes new procedures following SBA's structural reorganization. The branch or district office will forward its nomination of a Lender or the Lender's request for PLP status to the loan processing center rather than to a regional office. The district office's recommendation and the loan processing center's recommendation are forwarded to the AA/FA who makes the final determination. This section also provides for expansion and recertification of PLP status by the AA/FA after a review of the PLP Lender by SBA.

The section clarifies that if a PLP Lender is not already a CLP Lender in a territory into which it seeks to expand its PLP status, it will automatically obtain CLP status in the territory when it is granted an extension of its PLP status into that territory without approval from the District Office.

Proposed § 120.451(b)(current § 120.402-2) describes the factors SBA will consider in evaluating PLP nominations. SBA has eliminated the requirement that the Lender be a Certified Lender before being considered as a PLP Lender.

Proposed § 120.451(c) is a new provision providing that the AA/FA will designate the "area" in which a PLP Lender can make PLP loans. SBA believes that centralizing this function in the AA/FA will result in a uniform policy and practice.

The proposed rule consolidates the current § 120.403-1 (statutory ceiling), § 120.403-5 (interest rates), and § 120.403-6(b)(fees) into §§ 120.151, 120.213, 120.214, 120.221 and 120.222 respectively. The proposed rule deletes the current § 120.403-3 (credit allocation) because it is no longer used.

The proposed rule deletes the current § 120.403-6(a), which limits the fees a PLP lender can charge if it sells the guaranteed portion of a loan within six months of disbursement, because SBA feels there is no need to retain a cap on this fee. It consolidates the current § 120.403-7(c) into § 120.430.

The current § 120.403-7 has been rewritten as the new § 120.452(a) specifying the requirements of PLP loan processing. The section specifying the percentage of a PLP loan that SBA will guarantee has been moved from the current § 120.403-2 to § 120.452(a)(3). In proposed § 120.452(b), SBA describes the new procedures for approving a PLP loan by submitting documents to the loan processing center, which issues an SBA loan number.

The proposed rule consolidates the current §§ 120.404-1 through 120.405-1 concerning servicing and liquidation into proposed § 120.453, and deletes current §§ 120.405-2 through 120.405-4 because they are redundant or adequately described in SBA's SOP.

In proposed § 120.451(f), SBA has added a new provision to allow a PLP Lender to submit a request to expand its territory to the SBA loan processing center.

(c) Small Business Lending Companies ("SBLC"). The proposed rule revises the SBLC regulations for clarity and to eliminate details of the program better suited to an SOP. The sections have been renumbered, reorganized in a more logical structure, and presented in a question and answer format.

Finally, a provision on SBA's authority to suspend or revoke an SBLC's license is proposed at § 120.475.

#### 120 Subpart E—Loan Administration

New subpart E proposes general loan administration rules. Basically, these proposed rules reflect existing SBA policies. Any SBA field office can provide more detailed guidance concerning any aspect of these proposed rules.

Proposed §§ 120.510 and 120.511 describe the servicing responsibilities of the parties making loans. SBA services direct loans that it makes without the participation of a Lender, while Lenders service loans they make with the SBA guarantee. After SBA honors its guarantee, the Lender generally

continues to service the loan. Proposed § 120.512 describes this arrangement.

Proposed § 120.513 lists the servicing actions that require the concurrence of the Lender and the SBA because of their importance to the effective and efficient operation of SBA's loan program. The list includes the provisions contained in the participation agreement which a Lender executes with SBA to allow it to make 7(a) guaranteed loans, such as the alteration of terms and conditions of any loan instrument, the release of collateral with a value over 20 percent of the original amount of the loan, the acceleration of the maturity of a note, and the initiation of litigation.

SBA has the authority to purchase the guaranteed portion of a loan at any time, and proposed § 120.520 provides that a Lender may ask SBA to purchase the guaranteed portion when the Borrower has been continuously in default on its installment payments to the Lender for more than 60 days. If a Borrower cures a default (see § 120.523) before SBA purchases, the Lender's right to request purchase lapses. If SBA honors its guarantee, it does not waive any right it may have against the Lender because of the Lender's negligence, misconduct, or violation of the regulations, the guarantee agreement between the lender and SBA, or any of the loan instruments. SBA may sue to recover the amounts paid and may assert as a basis for recovery any of the grounds set forth in § 120.524.

A Borrower's obligation to pay principal and interest continues after SBA honors its guarantee. Proposed § 120.521 prescribes that the interest rate for which the Borrower is liable after the purchase continues to be the rate stated in the note if it is a fixed rate note. If a loan carries a fluctuating interest rate, the Borrower is obliged for the rate in effect at the time of the earliest uncured default (where there has been a default), or the rate in effect at the time when SBA purchases (where there has been no default). This means that no further fluctuations of interest can occur after SBA honors its guarantee.

Proposed § 120.522 provides that the interest rate for which SBA is liable when it purchases the guaranteed portion is the rate in the note if it is a fixed rate loan, or the rate in effect on the date of the earliest uncured default (if a default has occurred) or when SBA purchases (if there has been no default). The section provides that SBA pays a Lender no more than 120 days interest from the date of a Borrower's uncured default, plus any deferment period or time it takes for SBA to process a request to purchase. This cut-off period

encourages a Lender to make timely demand on SBA to purchase. Because extenuating circumstances may occur, the proposed section authorizes SBA to extend the 120 day time period for good cause.

Proposed § 120.523 defines "earliest uncured default" as the date on which a Borrower fails to pay a regular installment payment which remains unpaid for 60 days. If a Borrower makes a payment before a Lender requests SBA to honor its guarantee, the earliest uncured default date advances to the next unpaid installment date. This means that if a Borrower cures early defaults, the earliest uncured default date continues to move forward.

SBA does not have to honor its guarantee, under proposed § 120.524, if a Lender, amongst other things, fails to make, close, service, or liquidate an SBA guaranteed loan in a prudent fashion. The regulation contemplates that a Lender will comply with all the provisions of the regulations, the loan guarantee agreement it executed with SBA, the loan authorization (which is the document SBA issues to state that it is providing its guarantee for a specific loan request), and other loan documents. A Lender's failure to disclose material facts, a Lender's making material misrepresentations to SBA, or the Lender's failure to use SBA provided forms or exact computerized facsimile copies also justifies denial of liability under the guarantee. Other Lender actions which would support SBA's denial of liability on its guarantee include Lender's failure to pay the guarantee fee, Lender's late demand on SBA to purchase, or if the Borrower has paid the loan in full.

In order to assure the successful establishment and operation of a Borrower, proposed § 120.530 authorizes SBA to defer a Borrower's initial payments for a stated period of time. Under proposed § 120.531, SBA could extend the maturity of a loan for up to ten years beyond its stated maturity if the extension would aid in the orderly liquidation of the loan. Proposed § 120.532 defines "Moratorium" to be the period of time during which SBA assumes a Borrower's obligation to make installment payments on a guaranteed loan.

Under proposed § 120.533, SBA could grant a Moratorium if the business would become or remain insolvent without it; if the business would become or remain viable with a Moratorium; if a deferment is not available; if all the parties agree that SBA could stop making payments at any time; if the Borrower executes a demand

note to repay SBA's Moratorium payments; and if SBA obtains security which it deems necessary. These conditions supporting a Moratorium ensure that the parties know that their obligations continue and that SBA expects to be reimbursed for its advances under this procedure.

Proposed § 120.534 allows SBA to continue a Moratorium for six months. SBA may extend a Moratorium for up to five years if a Borrower could demonstrate its eventual ability to repay the original note (and the demand note required for the Moratorium). Proposed § 120.535 lists the repayment terms for a Moratorium. Under this section, the interest rate on the demand note is the same as for the guaranteed loan; SBA will apply repayments first to accrued interest and then to principal; and SBA may demand payment in full under the demand note or accept a repayment schedule.

Proposed § 120.540 establishes SBA's policy concerning the liquidation of collateral. Ordinarily, SBA does not liquidate collateral if there is any reasonable prospect that the Borrower or guarantor (other than SBA) may repay the loan within a reasonable period of time. Without the Borrower's consent, SBA has the authority to sell a direct loan, convert a direct loan to a guaranteed or immediate participation loan, or convert an immediate participation loan to a guaranteed loan or a loan owned solely by the Lender. Importantly, this authority enables SBA to take appropriate steps to resolve issues and problems concerning a loan. The proposed section also provides that SBA will generally use competitive bids or a negotiated sale to dispose of collateral. Under the proposed section, SBA and the Lender would share all loan payments and recoveries, all reasonable expenses, and any security or guarantee which the Lender or SBA may receive in connection with a loan. The proposed section provides that guarantors of financial assistance have no rights of contribution against SBA on a direct or guaranteed loan. The proposed section makes clear that SBA is not a co-guarantor with any other guarantor, and that SBA's guarantee is unique, distinctive, and of a totally different character than the guarantees offered by other parties.

Under applicable federal law, homestead protection for a farmer-Borrower covers a residence and a reasonable amount of adjoining real property ("the collateral") that are still occupied by the farmer-Borrower after being acquired by SBA as a result of foreclosure, a voluntary conveyance, or conveyance to the government by a

trustee in bankruptcy. The homestead protection provisions in the proposed rules cover SBA direct and guaranteed loans, as well as SBA disaster loans. Proposed § 120.550 specifies that a farmer-Borrower who defaults on an SBA loan would be allowed to lease the collateral from SBA. Under proposed § 120.551, SBA must notify the farmer-Borrower of the homestead protection rights within 30 days after SBA acquires the property. Under the proposed rule, the farmer-Borrower has to apply to the local SBA office for homestead protection within 90 days after SBA acquires the property, provide evidence that the farm produces farm income reasonable for the area and economic conditions, show that at least 60 percent of the farmer's gross annual income came from farm or ranch operations in at least 2 out of the last 6 years, that the farmer-Borrower has resided on the property during the preceding 6 years, and that the farmer is personally liable for the debt. This last point means that the SBA loan could have been made to any individual or entity, so long as the farmer-Borrower was personally liable for the debt.

Under proposed § 120.552, the farmer, under a lease with SBA, has to occupy the residence and pay a reasonable rent to SBA. The lease can be for a period of up to 5 years, and can be renewed for up to another 5 years. During the lease, or at its end, the lessee-farmer has the right of first refusal to reacquire the homestead property under terms and conditions no less favorable than those offered to any other purchaser. If the sale of the homestead property is an installment sale, the purchase agreement has to require a down payment of no less than 20 percent of the purchase price. The option price to the lessee-farmer must be the appraised fair market value determined by an independent appraisal. SBA cannot demand a payment for the homestead property that exceeds the appraised value.

Under proposed § 120.553, a farmer-Borrower can appeal denial of a homestead protection application to the AA/FA. Until a final decision is made, the farmer would be allowed to remain on the property. If a conflict exists between state law and the SBA homestead provisions, state law prevails.

#### 120 Subpart F—Secondary Market

SBA has consolidated subparts F, G, and H of Part 120 into one new Subpart F, governing SBA's secondary market for SBA guaranteed portions of loans. Subpart F covers central registration requirements, the pooling and sale of

SBA guaranteed portions, and the sale of individual SBA guaranteed portions that do not comprise part of a Pool. Provisions currently found in separate subparts have been consolidated for ease of understanding. SBA has renumbered and reordered the resulting provisions, but there are no substantive or policy changes.

The following is a conversion chart explaining where the current sections of subparts F, G, and H of 120 will be placed:

New section	Old section
120.600 ....	120.601, 120.700, 120.800.
120.601 ....	120.602, 120.702, 120.800, 120.802.
120.610 ....	120.706 and 120.803.
120.611 ....	120.707.
120.612 ....	120.710 and 120.807.
120.613 ....	120.301–2.
120.620 ....	120.711 and 120.701.
120.621 ....	120.801.
120.630 ....	120.703.
120.631 ....	120.704.
120.640 ....	120.709 and 120.806.
120.641 ....	120.713 and 120.809.
120.642 ....	120.708.
120.643 ....	120.805.
120.644 ....	120.804.
120.645 ....	120.605, 120.605–1.
120.650 ....	120.603, 120.604, 120.604–1, and 120.604–2.
120.651 ....	120.605–3.
120.652 ....	120.712 and 120.808.
120.660 ....	120.605–2, 120.705, and 120.810.

Proposed § 120.600 describes the secondary market. Section 120.601 contains definitions used in subpart F. Proposed § 120.610 provides that each Certificate representing either the entire individual guaranteed portion of an individual 7(a) guaranteed loan or an undivided interest in a Pool consisting of the SBA guaranteed portions of a number of 7(a) guaranteed loans ("Certificate") must be in registered form only. This means that there are no bearer Certificates. The section also specifies payment terms for Certificates.

Proposed § 120.611 describes the Pools which back Pool Certificates, including Pool characteristics and Pool Certificate interest rates. In § 120.612, SBA specifies conditions which must be met for an SBA guaranteed portion of a loan to be eligible to back a Certificate. Among other things, a loan must be current.

Proposed § 120.613 describes a secondary participation guarantee agreement (SPGA). Before an SPGA may be executed, the Lender must disburse the full amount of the loan, pay SBA's guarantee fee, and give SBA copies of the SPGA and note.

Proposed § 120.620 describes the extent of SBA's guarantee of a Pool Certificate. SBA guarantees the timely payment, whether or not collected, of principal and interest, and any prepayment of principal on the loans. SBA's guarantee to a Registered Holder in a Pool of SBA guaranteed portions of loans is backed by the full faith and credit of the United States.

Proposed § 120.621 describes the extent of SBA's guarantee of an individual guaranteed portion. SBA guarantees to purchase from the Registered Holder the guaranteed portion equal to the unpaid principal and interest, less deductions for the servicing fees of the Lender and the fiscal and transfer agent ("FTA"). SBA does not guarantee timely payment on individual guaranteed portions. SBA's guarantee to a Registered Holder is unconditional and is backed by the full faith and credit of the United States. SBA's guarantee is triggered when the Borrower defaults on installments of principal or interest, the Lender fails to send to the FTA any payments it received from the Borrower, or the FTA fails to send to the Registered Holder any payments it received from the Lender.

Proposed § 120.630 specifies the qualifications that an entity must possess to be a Pool Assembler. Among other things, the entity must be subject to regulation by an appropriate agency, have the financial capability to assemble acceptable guaranteed portions, and be in good standing with SBA. In proposed § 120.631, SBA specifies reasons for suspending a Pool Assembler from the secondary market.

Proposed § 120.640 describes the administration of the Pools and individual guaranteed portions. The

FTA maintains a registry of Certificate owners. Each Pool is self-liquidating, which means that there is no substitution of guaranteed portions of loans that are paid off by the borrower or SBA. If SBA pays a claim under a guarantee with respect to a Certificate, it is subrogated to the rights satisfied by the payment. This means that SBA can take any and all steps to be reimbursed for payments it makes. Absent an express statutory change, no federal, state or local law can preclude or limit SBA's exercise of its ownership rights in the portions of loans constituting the Pool against which Certificates are issued.

Proposed § 120.641 requires the Pool Assembler, Registered Holder of a Certificate representing an individual guaranteed portion, or any subsequent seller to disclose to the purchaser information on the Certificate's terms, conditions, and yield. Section 120.642 specifies the documents that a Pool Assembler must deliver to the FTA before the FTA can issue a Certificate, such as a Pool application form and documents which evidence the guaranteed portions which comprise the Pool. Section 120.643 specifies the documents that a seller must provide the FTA before the FTA can issue the initial Certificate for an individual SBA guaranteed portion, including documentation of ownership and a copy of the note that represents the guaranteed loan.

Proposed § 120.644 describes certain conditions applying to the sale of individual guaranteed portions. Each Certificate which represents the guaranteed portion of a single loan must be for the entire amount of the guaranteed portion. A Lender (or its Associate) cannot purchase the

guaranteed portion of a loan which it has made.

In § 120.645, SBA describes how to transfer a Certificate and what information a seller must supply to the FTA. Transfers must comply with Article 8 of the Uniform Commercial Code of New York State.

Under § 120.650 the FTA registers, issues, transfers title to, and redeems Certificates. Proposed § 120.651 tells a Registered Holder what information it must give to the FTA to replace a Certificate because of loss, theft, destruction, mutilation or defacement. Section 120.652 authorizes the FTA to collect fees approved by SBA.

Proposed § 120.660 specifies the reasons for SBA to suspend or revoke the privilege of a lender, broker, dealer, or Registered Holder to participate in the secondary market.

Subpart G—Microloan Demonstration Program

This proposed subpart revises, amends, and reorganizes the rules covering the microloan demonstration program ("microloans") currently located in Part 122. Substantive changes include: (1) § 120.708(c) provides a clearer understanding of how SBA determines the interest rate charged to an intermediary; (2) § 120.708(e) makes it clear that SBA loans to intermediaries are non-recourse unless an intermediary causes a loss to SBA by fraud or negligence; and (3) § 120.710 requires an intermediary to maintain accurate and current books and records, and to report periodically to SBA the status of its microloan portfolio.

The following conversion chart shows where to find the current Part 122 microloan sections:

Existing section	Action	New section
§ 122.61 (a) and (b) .....	Revised .....	§ 120.700 (a)-(c)
§ 122.61-2 (a)-(c) .....	Retained .....	§ 120.701 (a)-(c)
§ 122.61-2(d) .....	Revised .....	§ 120.701(d)
§ 122.61-2 (e)-(g) .....	Retained .....	§ 120.701 (e)-(g)
	New .....	§ 120.701(h)
§ 122.61-3(a) .....	Revised .....	§ 120.700(d)
§ 122.61-3(b) .....	Revised .....	§ 120.703
§ 122.61-3(c) .....	Revised .....	§ 120.703(c)
§ 122.61-4 (a) and (b) .....	Revised .....	§ 120.705
§ 122.61-4(c) .....	Deleted .....	
§ 122.61-5 .....	Revised .....	§ 120.704
§ 122.61-6 (a)-(c) .....	Revised .....	§ 120.707
§ 122.61-6(d) .....	Revised .....	§ 120.707
§ 122.61-6(e) .....	Revised .....	§ 120.707
§ 122.61-6(f) .....	Deleted .....	
§ 122.61-7 .....	Revised .....	§ 120.708
§ 122.61-8 (a)-(c) .....	Revised .....	§ 120.710
§ 122.61-8(d) .....	Deleted .....	§ 120.710
§ 122.61-9 (a) and (b) .....	Revised .....	§ 120.710
§ 122.61-10 .....	Retained .....	§ 120.712
§ 122.61-11(a) .....	Revised .....	§ 120.712
§ 122.61-11(b) .....	Revised .....	§ 120.702

Existing section	Action	New section
§ 122.61-11(c) .....	Retained .....	§ 120.712
§ 122.61-12 .....	Revised .....	§ 120.711

**Subpart H—Development Company (504) Loan Program**

This proposed rule makes current Part 108 a subpart of Part 120. The following conversion chart details the restructuring, subsection-by-subsection.

Those sections of Part 108 applicable to all business loans have been consolidated with the corresponding 7(a) provisions and placed in subpart A (“Policies Applying to All Business Loans”). Sections of Part 108 that apply only to the Development Company Loan

Program (“504 loans”) will be in this subpart H. Finally, some sections of Part 108 have been deleted as delineated in the chart.

**Part I—Section-by-Section Analysis of Part 108**

Former § 108 subpart	Proposed action on subpart	Comments on action
§ 108.1(a) .....	Condensed and moved to § 120.800 .....	No policy change.
§ 108.1(b) .....	Condensed and moved to § 120.800 .....	No policy change.
§ 108.1(c) .....	Rewritten and moved to § 120.860-§ 120.862 .....	No policy change.
§ 108.1(d) .....	Incorporated into § 120.862 .....	No policy change.
§ 108.1(e) .....	Eliminated as redundant; incorporated into § 120.176 .....	No policy change; eliminated because policy covered by other parts.
§ 108.2 .....	Definitions applying to all business loans are in § 120.10. Those applying solely to 504 loans are in § 120.801. Some terms applying only to a certain subsection are defined in the subsection.	See comments below on specific definitions.
§ 108.3(a) .....	Rewritten and placed into § 120.881(a). Definition of Substantial Increase in Unemployment is found in § 120.801.	No policy change.
§ 108.3(b) .....	Eliminated .....	Deleted because 501 and 502 programs have been eliminated.
§ 108.3(c) .....	Eliminated .....	Deleted because 501 and 502 programs have been eliminated.
§ 108.3(d) .....	Eliminated .....	Deleted because 501 and 502 programs have been eliminated.
§ 108.4(a) .....	Eliminated .....	No change of policy; rule eliminated because inherent in standard business practice.
§ 108.4(b) .....	Eliminated, but covered in § 120.826 .....	No change in policy; will be covered in SBA’s Standard Operating Procedure (SOP) or other policy guidance.
§ 108.4(c) .....	Eliminated, but covered in § 120.826 .....	No change in policy; will be covered in SBA’s SOP or other policy guidance.
§ 108.4(d) .....	Rewritten, clarified, and broadened. Most provisions consolidated with corresponding sections of current Part 120 into proposed § 120.140. See Note 4, subparts A and B. Those applying only to 504 loans are in § 120.855.	Minor policy change: SBA may waive prohibition on member of CDC Board of Directors being on another CDC’s Board.
§ 108.4(e) .....	Consolidated with § 108.4(d) and placed in § 120.40. Specific examples of conflicts of interest will be found in SOP. Prohibition against debt refinancing is in § 120.884.	No policy change.
§ 108.4(f) .....	Eliminated .....	Consolidated into § 120.176.
§ 108.5(a) .....	Covered in § 120.826; specific explanations and details in SOP .....	No policy changes.
§ 108.5(b) .....	Covered in § 120.826; specific explanations and details in SOP .....	Miniaturized reproductions of CDC records no longer referenced. Other technologies now available. Specific details will be in SOP.
§ 108.5(c) .....	Condensed into § 120.830(c) .....	No policy change.
§ 108.5(d) .....	Condensed into § 120.830(d) and (e) .....	Policy change -means of delivery will be detailed in SOP.
§ 108.5(e) .....	Eliminated .....	Report considered unnecessary under Presidential directive to reduce paperwork.
§ 108.5(f) .....	Eliminated .....	No policy change. Not required as regulation.
§ 108.6 .....	Eliminated .....	Reserved sections were removed.
§ 108.7(a) .....	Consolidated in § 120.140 .....	No policy change.
§ 108.7(b) .....	Eliminated. Provision covered in note and other closing documents .....	No policy change.
§ 108.8(a) .....	Credit elsewhere test consolidated and placed in § 120.101; evidence of need and use of personal resources by principals placed in § 120.102.	Major change of policy emphasis. See Note 6, subparts A and B.
§ 108.8(b) .....	Consolidated into § 120.150 and § 120.160 .....	No policy change.
§ 108.8(c) .....	Sound business purpose is addressed in § 120.120 and § 120.150. Size requirements is addressed in § 120.100(c) and § 120.880(b).	No policy change.

Former § 108 subpart	Proposed action on subpart	Comments on action
§ 108.8(d) .....	Replaced by § 120.111 .....	Major policy change. See Note 2, subparts A and B.
§ 108.8(e) .....	Condensed and placed in § 120.870 .....	No policy change.
§ 108.8(f) .....	Included in § 120.881. Financial and investment businesses addressed in § 120.110.	Clarifies policy. Ineligibility of project because relocation will cause unemployment may be rebutted if the relocation is crucial to the continued existence, economic wellbeing or competitiveness of the applicant, and the benefit to new community outweighs injury to old.
§ 108.8(g) .....	This subject is consolidated into § 120.110 and § 120.130 .....	No policy change.
§ 108.9 .....	Rewritten and placed in § 120.923(c) .....	No policy change.
§ 108.10 .....	Eliminated. Not necessary to include in regulation .....	No policy change.
§ 108.501 .....	Eliminated .....	Deleted because program eliminated, but SBA still regulates existing loans under this program. See § 120.180.
§ 108.501-1 .....	Eliminated .....	Deleted because program eliminated, but SBA still regulates existing loans under this program. See § 120.180.
§ 108.502 .....	Eliminated .....	Deleted because program eliminated, but SBA still regulates existing loans under this program. See § 120.180.
§ 108.502-1 .....	Eliminated .....	Deleted because program eliminated, but SBA still regulates existing loans under this program. See § 120.180.
§ 108.503(a) .....	Eliminated .....	No policy change; covered in § 120.1.
§ 108.503(b) .....	Rewritten and incorporated into § 120.2, § 120.860, § 120.861, and § 120.862.	No policy change.
§ 108.503(c) .....	Rewritten and placed in § 120.829 .....	Minor policy change. \$45,000 is substituted for 25% increase, which was \$43,750. Specific instructions and details in SOP and program guidance.
§ 108.503(d) .....	Condensed and placed in § 120.829(b) and (c) .....	No policy change; specific instructions and details in SOP and policy guidance.
§ 108.503-1(a) .....	Description of the program incorporated into § 120.2(c) and § 120.801. Eligible projects are in § 120.120, and applications for certification are in § 120.810.	No policy change
§ 108.503-1(b) .....	Rewritten and placed in § 120.820 through § 120.826, and § 120.855(a) ....	No policy change; incidental benefit to CDC Associate clarified to allow relationship in the regular course of business.
§ 108.503-1(c) .....	Rewritten and placed in § 120.821. See definition of Area of Operations in § 120.802. Extending a CDC's Area of Operations is in § 120.835 and § 120.836. Expiration of existing, temporary Expansions is in § 120.837. Case-by-case extensions are in § 120.838.	Important policy changes—see comments below.
§ 108.503-1(d) .....	Consolidated into § 120.822. Member or Board representation in another CDC is in § 120.855(b).	Policy change. See Note under current § 108.4(d) above. Specific details and instructions will be in SOP
§ 108.503-1(e) .....	Rewritten and placed in § 120.826 and § 120.827. SBIC limitation addressed in § 120.820.	No policy change; Specifics addressed in SOP.
§ 108.503-1(f) .....	Incorporated in § 120.827 .....	No policy change
§ 108.503-1(g) .....	Rewritten and placed in § 120.855(b) .....	Policy change. See Note under current § 108.4(d) above.
§ 108.503-2(a) .....	Rewritten and placed in § 120.810 .....	Small substantive change. Regional offices removed from process because of SBA reorganization. More information in SOP.
§ 108.503-2(b) .....	Rewritten and placed in § 120.811 .....	Minor procedural changes. 10 day period to submit notice to SBA eliminated; officer and director addresses no longer required in notice.
§ 108.503-2(c) .....	Rewritten and placed in § 120.981 .....	No policy changes.
§ 108.503-2(d) .....	Rewritten and placed in § 120.812 .....	No policy change.
§ 108.503-2(e) .....	Rewritten and placed in § 120.980 .....	No policy change.

Former § 108 subpart	Proposed action on subpart	Comments on action
§ 108.503-3(a) .....	Rewritten and placed in § 120.827 .....	No policy change.
§ 108.503-3(b) .....	Covered by § 120.827(a) .....	No policy change. Will be expounded upon in SOP.
§ 108.503-3(c) .....	Rewritten and placed in § 120.828 .....	Policy change. The number of loan approvals required to satisfy the minimum level of activity will now be specified in annual program announcement. See major policy change note (a) below.
§ 108.503-3(d) .....	Covered by § 120.826 .....	No policy change. Specifics in SOP.
§ 108.503-3(e) .....	Eliminated. ....	Deleted reserved section.
§ 108.503-3(f) .....	Rewritten and placed in § 120.830(a) and (b) .....	No policy change. SBA streamlining paperwork requirements under Presidential directive. Specifics in SOP.
§ 108.503-3(g) .....	Rewritten and placed in § 120.140(c). ....	No policy change.
§ 108.503-3(h) .....	Rewritten and placed in § 120.983 .....	No policy change.
§ 108.503-4(a) .....	Rewritten and placed in § 120.120, § 120.110, § 120.150 and § 120.193. See § 120.871 and § 120.872 for portions of new construction or existing building that may be leased.	No policy changes.
§ 108.503-4(b) .....	Rewritten and placed in § 120.130 and § 120.881 .....	Policy change. Airplanes in Alaska and Hawaii no longer eligible. Reference to assets limited in potential use or marketability deleted. This is part of the credit decision. The rule clarifies the eligibility status of heavy construction equipment. See comment (d) below.
§ 108.503-4(c) .....	Rewritten and placed in § 120.882(a)(2) and § 120.884(a) and (c). Statutory ceiling discussed in § 120.931; SBIC participation in § 120.103 and § 120.913; and administrative ceiling in § 120.932..	Policy change. Any expenditure made toward a project in anticipation of SBA assistance within 6 months of receipt by SBA of an application is eligible. No notice is required. See comment (b) below.
§ 108.503-5(a) .....	Rewritten and placed in § 120.120 and § 120.882 .....	No policy change.
§ 108.503-5(b) .....	Rewritten and placed in § 120.883 .....	No policy change.
§ 108.503-5(c) .....	Rewritten and placed in § 120.130 and § 120.884 .....	No policy change.
§ 108.503-5(d) .....	Discussed in § 120.882(a)(2). Land contributions in § 120.911 .....	See comment under current § 108.503-4(c) above and policy comment discussion (b) below. Specific instructions and explanations will be in SOP.
§ 108.503-6(a) .....	Rewritten and placed in § 120.883(c), § 120.961(a), and § 120.971(a)(1) ....	No policy change. Omits reference to \$2,500 in discussion of legal fees. See note (c). Specifics in SOP.
§ 108.503-6(b) .....	Rewritten and placed in § 120.936 .....	No policy change.
§ 108.503-6(c) .....	Rewritten and placed in § 120.961(b) .....	No policy change.
§ 108.503-6(d) .....	Rewritten and placed in § 120.971(a)(3) .....	No policy change.
§ 108.503-6(e) .....	Eliminated .....	Policy change. See Note 8, subparts A and B.
§ 108.503-7(a) .....	Rewritten. Certification of project completion placed in § 120.891. Certifications of no adverse change are in § 120.892..	No policy change. Specifics in SOP.
§ 108.503-7(b) .....	Rewritten and placed in § 120.890 .....	No policy change.
§ 108.503-7(c) .....	Rewritten and placed in § 120.962 .....	No policy change.
§ 108.503-8(a) .....	Rewritten and placed in § 120.900 .....	No policy change, but (3) is now called "Borrower contribution" instead of "the 503 Company injection".
§ 108.503-8(b) .....	Rewritten and placed in § 120.920 through § 120.925. Newly published (1/20/95) "other real estate owned" provision placed in § 120.923(a).	No policy change, but § 120.923(b) clarifies that some payments made by lienholder are allowed to maintain and protect the lien position.
§ 108.503-9 .....	Loan conditions are detailed in § 120.930 through § 120.941. Description of program is in § 120.3 and § 120.801.	No policy change.
§ 108.503-10 .....	Rewritten and placed in § 120.910 through § 120.913 .....	No policy change. Some specifics left for SOP.
§ 108.503-11 .....	Eliminated. Consolidated with current § 108.504(e) into § 120.954 .....	No policy change.
§ 108.503-12 .....	Rewritten and placed in § 120.960 .....	No policy change. Specifics in SOP.
§ 108.503-13(a) and (b) .....	Rewritten and placed in § 120.970. Quarterly reports discussed in § 120.830(f).	No policy change. Specifics moved to SOP.
§ 108.503-13(c) .....	Placed in 120.970. Incorporates § 120.513 .....	No policy changes. Specifics in SOP.
§ 108.503-13(d) .....	Rewritten and placed in § 120.971(a)(1) .....	No policy change.
§ 108.503-13(e) .....	Rewritten and placed in § 120.982 .....	No policy change.
§ 108.503-13(f) .....	Rewritten and placed in § 120.983 .....	No policy change.

Former § 108 subpart	Proposed action on subpart	Comments on action
§ 108.503-13(g) .....	Rewritten and placed in § 120.938 .....	No policy change.
§ 108.503-13(h) .....	Consolidated into § 120.530 .....	No policy change. Specific information and explanatory material will be in SOP.
§ 108.503-14 .....	Rewritten and placed in § 120.970 .....	No policy change. Specific information and explanatory material will be in SOP.
§ 108.503-15(a) and (b) .....	Rewritten and placed in § 120.972 .....	No policy change—specifics in SOP.
§ 108.503-15(c) and (d) .....	Eliminated .....	Deleted all reserve sections.
§ 108.503-15(e) .....	Rewritten and placed in § 120.984 .....	No policy change.
§ 108.504 (a), (b) and (c) ....	Consolidated into § 120.801 .....	No policy change.
§ 108.504(d) .....	Placed in § 120.934 .....	No policy change.
§ 108.504(e) .....	Rewritten and placed in § 120.954 .....	No policy change.
§ 108.504(f) .....	Rewritten and placed in § 120.941 .....	No policy change.
§ 108.504(g) .....	Eliminated. More suitable for inclusion in SOP .....	No policy change.
§ 108.504(h) .....	Rewritten and placed in § 120.941 .....	No policy change.
§ 108.504(i) .....	Consolidated into § 120.962 .....	No policy change.
§ 108.504(j) .....	Rewritten and placed in § 120.939 .....	No policy change.
§ 108.504(k) .....	Placed into § 120.941 .....	No policy change.
§ 108.504(l) .....	Eliminated .....	No policy change. Debentures are sold through Pools.
§ 108.504-1 .....	Condensed and placed in § 120.194 .....	Computer generated forms now may be used for all business loans, not just 504 loans.
§ 108.505(a) .....	Consolidated into § 120.1 .....	No policy change.
§ 108.505(b) .....	Consolidated into § 120.2 and § 129.801 .....	No policy change.
§ 108.505(c) .....	SBA guarantee discussed in § 120.801; timely payment on Certificate is in § 120.942; effect of other laws is in § 120.991.	No policy change.
§ 108.505(d) .....	Condensed and placed in 120.941 .....	No policy change.
§ 108.505(e) .....	Condensed and placed in § 120.942 .....	No policy change.
§ 108.505(f) .....	Placed in § 120.950, § 120.951 (selling agent), § 120.952 (fiscal agent), § 120.953 (trustee), and § 120.954 (central servicing agent). Bond/Insurance requirement moved to § 120.956(a).	No policy change, but reference to "Transfer Agent" has been deleted. "Trustee" has been used since 1986.
§ 108.505(g) .....	Eliminated. Regulations not necessary .....	No policy change, but "Pooler" is now referred to as "Underwriter" and specific conditions and duties will be in SOP.
§ 108.505(h) .....	Consolidated and placed in § 120.955 .....	No policy change.
§ 108.505(i) .....	Consolidated and placed in § 120.971(c) .....	No policy change.
§ 108.505(j) .....	Included in § 120.942(b) .....	No policy change.
§ 108.505(k) .....	Condensed into § 120.940 .....	No policy change.
§ 108.505(l) .....	Condensed into § 120.956 .....	No policy change.
§ 108.506 .....	Condensed and consolidated into § 120.140(i) .....	No policy change.
§ 108.507 .....	Rewritten and placed in § 120.850 .....	No policy change.
§ 108.507-1 .....	Merged into § 120.850 .....	No policy change.
§ 108.507-2 .....	Consolidated into § 120.851 .....	Minor policy change. ADCs may be for-profit, as well as non-profit status. SBA's purpose is to encourage more organizations to aid small businesses.
§ 108.507-3 .....	Condensed into § 120.851 .....	No policy change. Specifics will be in SOP.
§ 108.507-4 .....	Consolidated into § 120.850(a) .....	No policy change.
§ 108.507-5 .....	Reviews and audits consolidated into § 120.972. Suspension and revocation discussed in § 120.852.	No policy change.
§ 108.508-1 .....	This new program, published 4/26/95, was condensed and placed at § 120.840.	No policy change.
§ 108.509 .....	This new program, published 4/26/95, was condensed and placed at § 120.845.	No policy change.
New .....	120.831 .....	Minor policy change. CDCs would disclose to SBA & Borrower any compensation or remuneration received from a Lender or other party involved in a 504 loan to monitor any inducements.

## Part II—Major Policy Changes

(a) Area of Operations. During the policy review accompanying the regulatory rewriting, SBA focused much

of its attention on the question of what constitutes adequate service in an Area of Operation. Throughout the history of the 504 program there has been a great

divergence among CDCs in the number of loan approvals each year. While some CDCs have exhibited continued growth measured by their loan approvals and

ability to package, process and service loans, other CDCs have lagged behind. There are many complicated reasons for this, but the net result has been a patchwork of 504 service (measured by loan approvals) across the country, with many small businesses in some areas receiving 504 assistance while in other areas few, if any, small businesses have received such assistance.

SBA attempted to address this issue by permitting CDCs to expand temporarily into adjacent areas, and then, in 1993, by designating a minimum number of loan approvals per year which a CDC must average over the previous two fiscal year periods to retain certification as a CDC. The current number of required loan approvals is two. SBA also established the status of an Associate Development Company ("ADC"). Those CDCs unable or unwilling to meet the minimum number of loan approvals may become ADCs, thereby continuing to participate in the program goals of economic and community development without having to make loans. A number of CDCs have been decertified as a result of this policy and have opted for ADC status.

However, a focus on removal from CDC status does not address the real question of adequacy of service within an Area of Operations. What constitutes adequate service within a community? The statutory objectives of the 504 program are to provide a portion of long term fixed-asset financing for small business projects that provide jobs and result in economic development. Clearly, these goals cannot be met in an Area of Operations unless loans are being packaged, processed, approved, closed and serviced by one or more CDCs. Unfortunately, SBA is aware of too many locations across the country in which present CDCs are unable or unwilling to meet the small business demand for 504 loans. Transferring an existing CDC to ADC status does not address this inadequacy. SBA has concluded that the answer lies not in decertification, but in competition and customer service.

Therefore, in § 120.835, SBA is proposing that existing CDCs be permitted to expand into Areas of Operations that are not being adequately serviced. The expanding CDC would have to show that the proposed Area of Operations is not being adequately served by the existing CDCs and that the expanding CDC is well-qualified to serve it. SBA is not proposing any geographic or size limitation on CDCs applying to service a location, but such factors will be considered in evaluating the application. A CDC must apply in

writing to the SBA district office serving the geographic area in which the CDC proposes to expand.

In this context, SBA has concluded that there is no minimum loan approval number appropriate to every CDC in every location across the country. A small CDC with a rural Area of Operations and slow economic activity may be providing adequate service at a low level of approvals while a larger CDC in a metropolitan region with much economic activity may be providing inadequate service, despite having a greater number of loan approvals.

SBA has also concluded that adequate service includes adequate servicing of loans, as well as the number of loan approvals. Thus, any CDC seeking to expand will have to show that it has a history of adequate experience and expertise in both loan packaging and servicing, and that the existing CDCs in the proposed area of expansion have not been adequately packaging or servicing loans. Even if the number of loan approvals does not accurately represent the competence of a CDC, it does accurately reflect the adequacy of the market penetration of 504 financing in the proposed area of expansion.

In general, SBA will consider an Area of Operations inadequately served if the existing CDCs in the Area of Operations have not averaged, over the last two fiscal years, sufficient loan approvals for the population, as published by SBA in an annual program announcement. SBA will establish the initial formula in a program announcement upon publication of the final rule, but would like the benefit of comments on this subject before committing any specific numbers to print. SBA is considering a two or three tier formula based on the current national averages for CDC loan approvals per number of population. Suggestions have been received that the formula should be based not on population, but on the number of small businesses in the Area of Operations or some other factor. SBA is interested in comments and would like recommendations on how, if at all, to incorporate a servicing component into its approach.

SBA is proposing (§ 120.837) that all existing, temporary expansions of Areas of Operations will expire automatically 6 months after the effective date of these regulations, unless a CDC applies for permanent expansion into that Area before the expiration date. SBA believes that CDCs will best serve the small business community by making a permanent commitment to an Area of Operations. Upon showing good cause, a CDC will still be able to apply to SBA

to make an individual loan for a Project outside its Area of Operations in an area not being adequately served by other CDCs (§ 120.838). Note also that the Borrower may write to the AA/FA (but not the District Director) to request the servicing of a CDC not currently serving the area. SBA has added this provision to give Borrowers more flexibility if they have a concern about the services of a particular CDC.

(b) Expenditures in Anticipation of Project. In the current regulations, costs incurred by a Borrower in anticipation of receiving a 504 loan are not eligible to be included in Project costs unless the applicant has filed a written notice with the CDC and SBA within 60 days of incurring the expense and SBA gives written approval. As a result, CDCs and SBA receive notices from many potential borrowers considering 504 financing who desire to maximize potential financing. Many of these businesses never actually apply or their applications are denied. In those cases, the written notices are a useless paperwork burden on SBA, the CDC and the applicant.

Therefore, SBA is proposing (§ 120.882(a)(2)) to eliminate the requirement for written notice. Any expense incurred toward a Project within six months of receipt by SBA of a complete loan application will be an eligible Project cost.

(c) Legal Fees. The Borrower's closing costs, including legal fees, are eligible for inclusion in the 504 loan. Typically, legal services are provided by the CDC's counsel, who is usually experienced in closing 504 loans and thus, is able to do so cost effectively. Sometimes, a Borrower will also retain an attorney. Under the current regulations, the CDC may charge the Borrower up to \$2,500 for the legal services performed by the CDC counsel, unless SBA approves a higher fee in a complex case. If the fee is more than \$2,500, the CDC must pay the difference. The CDC collects the fee at closing and forwards it to the closing attorney.

The \$2,500 figure in the regulation has engendered much debate within the industry. Many CDCs feel the figure establishes a minimum base for attorney services and is, therefore, anti-competitive. On the other hand, during the past five months, SBA has conducted several expedited closing training sessions for CDC counsel. Many attorneys feel that the figure establishes a ceiling for attorney services and is, therefore, anti-competitive. There appears to be a wide range of prices charged by CDC counsel for closing services. Most CDCs try to minimize

counsel fees to reduce costs to the Borrower.

SBA has determined that there is no reason for SBA to refer to any legal fee amount. Whether it is viewed as a ceiling or a base, the \$2,500 reference has apparently caused misunderstanding and may have had an effect on legal fees charged. SBA believes legal fees should be determined by the competitive market. Therefore, proposed §§ 120.883(d) and 120.961(a), omit any reference to amount.

(d) Eligible Use of Proceeds. In the current regulations, airplanes are not eligible for 504 loans, except that Alaskan and Hawaiian Projects may include airplanes not exceeding 20 percent of the Project cost, if they are indispensable to the Project. SBA proposes to eliminate this exception (§ 120.884(d)(2)), previously justified because of the great distances people must travel in those states. But distances are great in many mainland states, as well, and airplanes simply are not directly attributable and necessary for a Project.

Also, in the current regulations there is no direct reference to the eligibility of construction equipment as a distinct sub-category of equipment and machinery. CDCs and SBA often receive questions from potential Borrowers as to whether construction equipment is eligible for 504 financing. The proposed rule in § 120.884(d)(3) clarifies that construction equipment is ineligible for 504 financing unless it is heavy duty equipment integral to the operation of a business and meeting the IRS definition of capital equipment. Note also that § 120.884(d)(1) clarifies SBA policy that short term equipment is a permitted use of loan proceeds if the equipment is essential to the Project and reflects a minor percentage of the loan. This is not a change in policy.

(e) Definitions. SBA has created several new definitions to help make the regulation easier to understand. Comments and suggestions will be appreciated.

Several definitions clarify terms long associated with the 504 program which were included in the regulations, but were not defined. These include "Area of Operations," "Certificate," "Debenture," "Job Opportunity," and "Substantial Increase in Unemployment."

Finally, some key words have been replaced with more useful and apt words. A "Small Business Concern" is now a "Small Business." The term "Underwriter" has replaced "Pooler." The term "Project" has replaced "Plant." "Project Property" is a new

definition previously undefined in the regulation.

(f) Minor Policy Changes. In proposed § 120.828, the minimum level of CDC lending activity is no longer set at a specific number; SBA will retain the ability to change this number through its program announcements based on program performance and the economy. In proposed § 120.939(b), CDCs will be liable for SBA losses incurred by "wrongful CDC conduct" as well as in cases of fraud and negligence.

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 involves internal administrative procedures and would not be considered a significant rule within the meaning of Executive Order 12866 and 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. It is not likely to have an annual economic effect of \$100 million or more, result in a major increase in costs or prices, or have a significant adverse effect on competition or the United States economy.

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 record keeping requirements.

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

##### 13 CFR Part 108

Equal employment opportunity, Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

##### 13 CFR Part 116

Coastal Zone, Flood insurance, Flood plains, Lead poisoning, Small businesses, Veterans.

##### 13 CFR Part 120

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

##### 13 CFR Part 122

Community development, Employee benefit plans, Energy conservation, Environmental protection, Exports, Individuals with disabilities, Loan programs-business, Loan programs-energy, Loan programs-veterans, Microloans, Reporting and recordkeeping requirements, Small businesses, Solar energy, Trusts and trustees, Veterans.

##### 13 CFR Part 131

Loan programs-business, Small businesses.

Accordingly, pursuant to the authority set forth in sections 5 (b)(1) and (b)(6) of the Small Business Act, 15 U.S.C. 634(b)(6) and 636 (a) and (h), SBA hereby proposes to amend Chapter I of Title 13, Code of Federal Regulations (CFR), as follows:

1. Part 120 would be revised to read as follows:

### PART 120—BUSINESS LOANS

General Descriptions of SBA's Business Loan Programs

Sec.

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#### General Descriptions of SBA's Business Loan Programs

##### § 120.1 Which loan programs does this part cover?

This Part regulates SBA's financial assistance to small businesses under its general business loan programs ("7(a) loans") authorized by section 7(a), 15 U.S.C. 636(a) of the Small Business Act ("the Act"), its microloan demonstration loan program ("Microloans") authorized by section 7(m), 15 U.S.C. 636(m) of the Act, and its development company program ("504 loans") authorized by Title V of the Small Business Investment Act, 15 U.S.C. 695 to 697f ("Title V"). These three programs constitute the business loan programs of the SBA.

##### § 120.2 Descriptions of the business loan programs.

(a) *7(a) loans.* (1) 7(a) loans provide financing for general business purposes and may be:  
 (i) A direct loan by SBA;  
 (ii) An immediate participation loan by a Lender and SBA; or  
 (iii) A guaranteed loan (deferred participation) by which SBA guarantees a portion of a loan made by a Lender.  
 (2) A guaranteed loan is initiated by a Lender agreeing to make an SBA

guaranteed loan to a small business and applying to SBA for SBA's guarantee under a blanket guarantee agreement (participation agreement) between SBA and the Lender. If SBA agrees to guarantee (authorizes) a portion of the loan, the Lender funds and services the loan. If the small business defaults on the loan, SBA's guarantee requires SBA to purchase its portion of the outstanding balance, upon demand by the Lender and subject to specific conditions. Regulations specific to 7(a) loans are found in subpart B of this part.

(b) *Microloans.* SBA makes loans and loan guarantees to non-profit Intermediaries that make short-term loans up to \$25,000 to eligible small businesses for general business purposes, except payment of debts. SBA also gives grants to Intermediaries for use in providing management assistance and counseling to small businesses. Regulations specific to these loans are found in subpart G of this part.

(c) *504 loans.* Projects involving 504 loans require long-term fixed-asset financing for small businesses. A Certified Development Company (CDC) provides the final portion of this financing with a 504 loan made from the proceeds of a Debenture issued by the CDC, guaranteed 100 percent by SBA (with the full faith and credit of the United States), and sold to investors. The regulations specific to these loans are found in subpart H of this part.

##### § 120.3 Pilot programs.

The Administrator of SBA may from time to time suspend, modify, or waive rules for a limited period of time to test new programs or ideas. The Administrator shall publish a document in the Federal Register explaining the reasons for these actions.

#### Definitions

##### § 120.10 Definitions.

The following terms have the same meaning wherever they are used in this part. Defined terms are capitalized wherever they appear.

*Associate.* (1) An Associate of a Lender or CDC is:

- (i) An officer, director, member, or key employee, or an agent involved in the loan-making process;
  - (ii) A Close Relative of any individual in paragraph (1)(i) of this definition; and
  - (iii) Any entity in which one or more individuals referred to in paragraphs (1) (i) and (ii) of this definition own or control at least 10 percent.
- (2) An Associate of a small business is:
- (i) An officer, director, member, owner, principal, key employee, or

agent authorized to act on behalf of the small business;

(ii) A Close Relative of any individual in paragraph (2)(i) of this definition;

(iii) Any entity in which one or more individuals referred to in paragraphs (2) (i) and (ii) of this definition owns or controls at least 10 percent; and

(iv) Any individual or entity in control of or controlled by the small business (except a Small Business Investment Company ("SBIC") licensed by SBA).

(3) For purposes of this definition, the time during which an Associate relationship exists commences six months before the following dates and continues as long as the certification, participation agreement, or loan is outstanding:

(i) For a CDC, the date of certification by SBA;

(ii) For a Lender, the date of application for a loan guarantee on behalf of an applicant; or

(iii) For a small business, the date of the loan application to SBA, the CDC, the Intermediary, or the Lender.

*Authorization* is SBA's written agreement providing the terms and conditions under which SBA will make or guarantee business loans. It is not a contract to make a loan.

*Borrower* is the obligor of an SBA business loan.

*Certified Development Company* ("CDC") is an entity authorized by SBA to deliver 504 financing to small businesses.

*Close Relative* is a spouse; a parent; or a child or sibling, or the spouse of any such person.

*Eligible Passive Company* is a small entity which does not engage in regular and continuous business activity, which leases real or personal property to an Operating Company for use in the Operating Company's business, and which complies with the conditions set forth in § 120.111.

*Intermediary* is the entity in the Microloan program that receives SBA financial assistance and makes loans to small businesses in amounts up to \$25,000.

*Lender* is an institution that has executed a participation agreement with SBA under the guaranteed loan program.

*Loan Instruments* are the Authorization, note, instruments of hypothecation, and all other agreements and documents related to a loan.

*Operating Company* is an eligible small business actively involved in conducting business operations now or about to be located on real property owned by a Passive Company, or using or about to use in its business

operations personal property owned by a Passive Company.

*Preference* is any arrangement giving a Lender or a CDC a preferred position compared to SBA relating to the making of a business loan with respect to such things as repayment, collateral, guarantees, control, maintainance of a compensating balance, purchase of a Certificate of deposit or acceptance of a separate or companion loan, without SBA's consent.

*Rural Area* is a political subdivision or unincorporated area in a non-metropolitan county (as defined by the Department of Agriculture), or, if in a metropolitan county, any such subdivision or area with a resident population under 20,000 which is designated by SBA as rural.

*Service Provider* is an entity that contracts with a Lender or CDC to perform management, marketing, legal or other services.

### Subpart A—Policies Applying to All Business Loans

#### Eligibility Requirements

#### § 120.100 What are the basic requirements for all Borrowers?

To be an eligible Borrower for an SBA loan, a small business must:

- (a) Be an operating business (except for loans to Passive Companies);
- (b) Be organized for profit;
- (c) Be located in the United States;
- (d) Be small under the size requirements of Part 121 of this chapter (including affiliates). See subpart H of this part for the size standards of Part 121 of this chapter which apply only to 504 loans; and
- (e) Must demonstrate a need for the desired credit.

#### § 120.101 Credit not available elsewhere.

SBA provides business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources. SBA requires the Lender or CDC to certify or otherwise show that the desired credit is unavailable to the applicant on reasonable terms and conditions from non-Federal sources without SBA assistance, taking into consideration the prevailing rates and terms in the community in or near where the applicant conducts business, for similar purposes and periods of time. Submission of an application to SBA by a Lender or CDC constitutes certification by the Lender or CDC that it has examined the availability of credit to the applicant, has based its certification upon that examination, and has

documentation in its file to support the certification.

#### § 120.102 Funds not available from alternative sources, including personal resources of principals.

An applicant for a business loan must show that the desired funds are not available from the personal resources of the applicant's principals or other sources such as the sale of the applicant's assets or securities. SBA may require the use of personal resources before a loan will be granted, unless SBA determines that undue hardship would result or if the loan is to an employee trust.

#### § 120.103 Are farm enterprises eligible?

Federal financial assistance to agricultural enterprises is generally made by the United States Department of Agriculture (USDA), but may be made by SBA under the Memorandum of Understanding signed by SBA and USDA. Farm-related businesses are eligible businesses under SBA's business loan programs.

#### § 120.104 Are businesses financed by SBICs eligible?

SBA may make or guarantee loans to a business financed by an SBIC if SBA's collateral position will be superior to that of the SBIC. SBA may also make or guarantee a loan to an otherwise eligible small business which temporarily is owned or controlled by an SBIC under the regulations in part 107 of this chapter. SBA neither guarantees SBIC loans nor makes loans jointly with SBICs.

#### § 120.105 Special consideration for veterans.

SBA will give special consideration to a small business owned by a veteran or, if the veteran chooses not to apply, to a business owned or controlled by one of the veteran's dependents. If the veteran is deceased or permanently disabled, SBA will give special consideration to one survivor or dependent. SBA will process the application of a business owned or controlled by a veteran or dependent promptly, resolve close questions in the applicant's favor, and pay particular attention to maximum loan maturity. For SBA loans, a veteran is a person honorably discharged from active military service.

#### Ineligible Businesses and Eligible Passive Companies

#### § 120.110 What businesses are ineligible for SBA business loans?

The following types of businesses are ineligible:

(a) Non-profit businesses (for-profit subsidiaries are eligible);

(b) Financial businesses primarily engaged in the business of lending, such as banks, finance companies, and factors (pawn shops, although engaged in lending, may qualify in some circumstances);

(c) Passive businesses owned by developers and landlords that do not actively use or occupy the assets acquired or improved with the loan proceeds (except Eligible Passive Companies under § 120.111);

(d) Life insurance companies;

(e) Businesses located in a foreign country (businesses in the U.S. owned by aliens may qualify);

(f) Pyramid sale distribution plans;

(g) Businesses deriving more than one-third of gross annual income from legal gambling activities);

(h) Businesses engaged in any illegal activity;

(i) Private clubs and businesses which limit the number of memberships for reasons other than capacity;

(j) Government-owned entities (except for businesses owned or controlled by a Native American tribe);

(k) Businesses principally engaged in teaching, instructing, counseling or indoctrinating religion or religious beliefs, whether in a religious or secular setting;

(l) Consumer and marketing cooperatives (producer cooperatives are eligible);

(m) Loan packagers earning 30 percent or more of their gross annual revenue from packaging SBA loans;

(n) Businesses with an Associate considered to have control under Part 121 who is incarcerated, on probation, on parole, or subject to pending felony charges;

(o) Businesses in which the Lender or CDC, or any of its Associates owns an equity interest (unless waived by SBA for good cause in the case of minor ownership interests);

(p) Businesses which:

(1) Present live performances of a prurient sexual nature; or

(2) Derive significant gross revenue through the sale of products or services, or the presentation of depictions or displays, of a prurient sexual nature;

(q) Unless waived by SBA for good cause, businesses that have previously defaulted on a Federal loan or Federally assisted financing, resulting in the Federal government or any of its agencies or Departments sustaining a loss in any of its programs, and businesses owned or controlled by an applicant or any of its Associates which previously owned, operated, or controlled a business which defaulted

on a Federal loan and caused the Federal government or any of its agencies or Departments to sustain a loss in any of its programs. For purposes of this section, a compromise agreement shall also be considered a loss; and

(r) Businesses primarily engaged in political or lobbying activities.

**§ 120.111 What conditions must an Eligible Passive Company satisfy?**

An Eligible Passive Company must use loan proceeds to acquire or lease, and/or improve or renovate real or personal property (including eligible refinancing) that it leases to an Operating Company for the conduct of the Operating Company's business. Any ownership structure or legal form may qualify as a Eligible Passive Company, except revocable trusts and other grantor trusts.

(a) Conditions that apply to all legal forms:

(1) The Operating Company is an eligible small business, and the proposed use of the proceeds would have been an eligible use if the Operating Company were obtaining the financing directly;

(2) Both the Eligible Passive Company and the Operating Company must be small under the appropriate size standards in part 121 of this chapter;

(3) The lease between the Eligible Passive Company and the Operating Company must be in writing and must be subordinated to SBA's mortgage, trust deed lien, or security interest on the property. Also, the Eligible Passive Company (as landlord) must furnish as collateral for the loan an assignment of all rents paid under the lease;

(4) The lease, including options to renew exercisable solely by the Operating Company, must have a remaining term at least equal to the term of the loan;

(5) The Operating Company must be a guarantor or a co-borrower (with the Eligible Passive Company) of the loan; and

(6) Each holder of an ownership interest constituting at least 20 percent of the Eligible Passive Company or the Operating Company must guarantee the loan (the trustee shall execute the guarantee on behalf of any trust).

(b) Additional conditions that apply to irrevocable trusts. A trust qualifying as a Eligible Passive Company may engage in other activities as authorized by its trust agreement. For purposes of this section, the trustee shall certify to SBA that:

(1) The trustee has authority to act;

(2) The trust is irrevocable, and is not regarded as a grantor trust for tax purposes;

(3) The trust has the authority to borrow funds, pledge trust assets, and lease the property to the Operating Company;

(4) The trustee has provided accurate, pertinent language from the trust agreement confirming the above; and

(5) The trustee has provided and will continue to provide SBA with a true and complete list of all trustees and donors.

Uses of Proceeds

**§ 120.120 What are eligible uses of proceeds?**

A small business must use an SBA loan for sound business purposes. The uses of proceeds are prescribed in each loan's Authorization.

(a) A Borrower may use loan proceeds from any SBA loan to:

- (1) Acquire land (by purchase or lease);
- (2) Improve a site (grading, streets, parking lots, landscaping);
- (3) Purchase an existing building;
- (4) Convert, expand or renovate an existing building;
- (5) Construct a new building; and/or
- (6) Acquire (by purchase or lease) and install machinery and equipment (in the 504 program, with a useful life of at least 10 years and at a fixed location, unless essential to the Project).

(b) A Borrower may also use 7(a) and microloan proceeds for:

- (1) Inventory;
- (2) Supplies;
- (3) Raw materials;
- (4) Working capital; and
- (5) Refinancing certain outstanding debts.

**§ 120.130 Restrictions on uses of proceeds.**

SBA will not authorize nor may a Borrower use loan proceeds for the following purposes (including the replacement of funds used for any such purpose):

(a) Payments, distributions or loans to Associates of the applicant (except for ordinary compensation for services rendered);

(b) Refinancing a debt owed to a Small Business Investment Company ("SBIC");

(c) Speculation in any kind of real or personal property;

(d) Floor plan financing or other revolving line credit, except under § 120.390;

(e) Investments in real or personal property acquired and held primarily for sale, lease, or investment and not used within 3 years in an otherwise eligible business (except for a loan to an Eligible Passive Company or to a small contractor under § 120.310);

(f) A purpose which does not benefit the small business; or

(g) Any use restricted by §§ 120.201–120.203 and 120.884 (specific to 7(a) loans and 504 loans respectively).

Ethical Requirements

**§ 120.140 What ethical requirements apply to participants?**

Lenders, Intermediaries, CDCs, Associate Development Companies ("ADCs") and their Associates (in this section "Participants") must act ethically and exhibit good character. Ethical indiscretion of an Associate shall be attributed to the Participant. A Participant must promptly notify SBA if it obtains information concerning the unethical behavior of an Associate. The following are examples of such unethical behavior. A Participant may not:

- (a) Self-deal;
- (b) Have a real or apparent conflict of interest with a small business with which it is dealing (including any of its Associates) or SBA;
- (c) Own an equity interest in a business that has received or is applying to receive SBA financing (during the term of the loan or within 6 months prior to the loan application);
- (d) Be incarcerated, on parole, or on probation;
- (e) Knowingly misrepresent or make a false statement to SBA;
- (f) Engage in conduct reflecting a lack of business integrity or honesty;
- (g) Be a convicted felon, or have an adverse final civil judgment (in a case involving fraud, breach of trust, or other conduct) that would cause the public to question the Participant's business integrity, taking into consideration such factors as the magnitude, repetition, harm caused, and remoteness in time of the activity or activities in question;
- (h) Accept funding from any source that restricts, prioritizes, or conditions the types of small businesses that the CDC, ADC, or Intermediary may assist under an SBA program or that imposes any conditions or requirements upon recipients of SBA assistance inconsistent with SBA's loan programs or regulations;
- (i) Fail to disclose to SBA all relationships between the small business and its Associates, the Participant, and/or the lenders financing the Project;
- (j) Fail to disclose to SBA whether the loan will:

- (1) Reduce the exposure of a Lender in a position to sustain a loss;
- (2) Directly or indirectly finance the purchase of real estate, personal property or services (including insurance) from the Participant;
- (3) Repay or refinance a debt due a Participant;

(4) Require the small business, or an Associate, to invest in the Participant (except for institutions which require an investment from all members as a condition of membership, such as a Production Credit Association); or

(5) Involve a Lender, CDC or Associate that has issued a commitment to make or consider the loan prior to receipt of the loan application, including a forward commitment to a builder or developer; or

(k) Engage in any activity which taints its objective judgment in evaluating the loan.

#### Credit Criteria for SBA Loans

##### § 120.150 What are SBA's lending criteria?

The Borrower (and the Operating Company) must be creditworthy. Loans must be so sound as to assure repayment. SBA will consider:

(a) Character, reputation, and credit history of the Borrower (and the Operating Company, if applicable), its Associates, and guarantors;

(b) Experience and depth of management;

(c) Strength of the business;

(d) Past earnings, projected cash flow, and future prospects;

(e) Ability to repay the loan with earnings from the business;

(f) Sufficient invested equity to operate on a sound financial basis;

(g) Potential for long-term success; and

(h) Nature and value of collateral. (Inadequate collateral will not be the sole reason for denial of a loan request.)

##### § 120.151 What is the statutory limit for total loans to a Borrower?

The aggregate amount of the SBA portions of all loans to a single Borrower, including the Borrower's affiliates as defined in part 121 of this chapter, shall not exceed \$750,000, except as otherwise authorized by statute for a specific loan program.

##### § 120.160 Loan conditions.

The following requirements are normally required by SBA for all business loans:

(a) *Personal guarantees.* Associates and holders of at least a 20 percent ownership interest generally must guarantee the loan. SBA, in its discretion, may require holders of interests of less than 20 percent to guarantee the loan.

(b) *Appraisals.* SBA may require professional appraisals of the applicant's and principals' assets, a survey, or a feasibility study.

(c) *Hazard Insurance.* SBA requires hazard insurance on all collateral.

(d) *Taxes.* If any portion of the loan proceeds will be used for working

capital, the applicant may not use any of the proceeds to pay past-due Federal and state payroll taxes.

##### § 120.161 Lending limits.

The outstanding balance of all SBA financial assistance to a Borrower and its affiliates under the business loan programs covered by this Part must not exceed \$750,000 (except as otherwise authorized for a specific loan program).

#### Requirements Imposed Under Other Laws and Orders

##### § 120.170 Flood insurance.

Under the Flood Disaster Protection Act of 1973 (Sec. 205(b) of Public Law 93-234; 87 Stat. 983 (42 U.S.C. 4000 *et seq.*)), a loan recipient must obtain flood insurance if any building (including mobile homes), machinery, or equipment acquired, installed, improved, constructed, or renovated with the proceeds of SBA financial assistance is located in a special flood hazard area. The requirement applies also to any inventory (business loan program), fixtures or furnishings contained or to be contained in the building. Mobile homes on a foundation are buildings. SBA, Lenders, CDCs, and Intermediaries must notify Borrowers that flood insurance must be maintained.

##### § 120.171 Compliance with child support obligations.

Any holder of 50% or more of the ownership interest in the recipient of an SBA loan must certify that he or she is not more than 60 days delinquent on any obligation to pay child support arising under:

(a) An administrative order;

(b) A court order;

(c) A repayment agreement between the recipient and the custodial parent; or

(d) A repayment agreement between the recipient and a State agency providing child support enforcement services.

##### § 120.172 Flood-plain and wetlands management.

(a) All loans must conform to requirements of Executive Orders 11988, "Flood Plain Management" (3 CFR, 1977 Comp., p. 117) and 11990, "Protection of Wetlands" (3 CFR, 1977 Comp., p. 121). Lenders, Intermediaries, CDCs, and SBA must comply with requirements applicable to them. Applicants must show:

(1) Whether the location for which financial assistance is proposed is in a floodplain or wetland;

(2) If it is in a floodplain, that the assistance is in compliance with local land use plans; and

(3) That any necessary construction or use permits will be issued.

(b) Generally, there is an 8-step decision making process with respect to:

(1) Construction or acquisition of anything, other than a building;

(2) Repair and restoration equal to more than 50% of the market value of a building; or

(3) Replacement of destroyed structures.

(c) SBA may determine for the following types of actions, on a case-by-case basis, that the full 8-step process is not warranted and that only the first step (determining if a proposed action is in the base floodplain) need be completed:

(1) Actions located outside the base floodplain;

(2) Repairs, other than to buildings, that are less than 50% of the market value;

(3) Replacement of building contents, materials, and equipment;

(4) Hazard mitigation measures;

(5) Working capital loans; and

(6) SBA loan assistance of \$1,500,000 or less.

##### § 120.173 Lead-based paint.

If loan proceeds are for the construction or rehabilitation of a residential structure, lead-based paint may not be used on any interior surface, or on any exterior surface that is readily accessible to children under the age of 7.

##### § 120.174 Earthquake hazards.

When loan proceeds are used to construct a new building or an addition to an existing building, the construction must conform with the "National Earthquake Hazards Reduction Program (NEHRP) Recommended Provisions for the Development of Seismic Regulations for New Buildings," obtainable from the Interagency Committee on Seismic Safety in Construction.

##### § 120.175 Coastal barrier islands.

SBA and Intermediaries may not make or guarantee any loan within the Coastal Barrier Resource System.

##### § 120.176 Compliance with other laws.

All SBA loans are subject to all applicable laws, including (without limitation) the civil rights laws (see Parts 112, 113, 117 and 136 of this chapter), prohibiting discrimination on the grounds of race, color, national origin, religion, sex, marital status, disability or age. SBA requests agreements or evidence to support or document compliance with these laws, including reports required by applicable statutes or the regulations in this chapter.

**Enforceability Despite Rule Changes****§ 120.180 Are rules enforceable if they are changed later?**

Regulations and contractual provisions in effect at the time of a transaction govern an SBA loan financing transaction, notwithstanding subsequent rule or contract changes. SBA may conduct an enforcement action regarding any violation of provisions of regulations or contracts applicable at the time, but no longer in effect or in use.

**Loan Applications****120.190 Where does an applicant apply for a loan?**

An applicant for a loan should apply to:

- (a) A Lender for a guaranteed or immediate participation loan;
  - (b) A CDC for a 504 loan;
  - (c) An Intermediary for a Microloan;
- or
- (d) SBA for a direct loan.

**§ 120.191 The contents of a business loan application.**

SBA requires that an application for a business loan contain, among other things, a description of the history and nature of the business, the amount and purpose of the loan, the collateral offered for the loan, current financial statements, historical financial statements (or tax returns if appropriate) for the past three years, and a business plan, when applicable. Personal histories and financial statements will be required from principals of the applicant (and the Operating Company, if applicable).

**§ 120.192 Approval or denial.**

Applicants receive notice of approval or denial by the Lender, CDC, Intermediary, or SBA, as appropriate. Notice of denial will include the reasons. If a loan is approved, an Authorization will be issued.

**§ 120.193 Reconsideration after denial.**

An applicant or recipient of a business loan may request reconsideration of a denied loan or loan modification request within 6 months of denial. Applicants denied due to a size determination can appeal that determination under part 121 of this chapter. All others, including those requesting modification of an existing loan condition, can only appeal to the office that denied the initial loan application or request. To prevail, the applicant must demonstrate that it has overcome all legitimate reasons for denial. Six months after denial, a new application is required. If the

reconsideration is denied, an applicant may request a final reconsideration by the AA/FA, whose decision is final.

**Computerized SBA Forms****§ 120.194 Use of computer forms.**

Any applicant or other party involved in SBA Business Loan Programs may use computer generated SBA application forms, closing forms, and other forms designated by SBA if the forms are exact reproductions of SBA forms.

**§ 120.195 Duty of Lender, CDC, Intermediary Lender, and Borrower to report fees.**

(a) A Lender, CDC, or Intermediary Lender must report to SBA all fees of which it has knowledge or which it charges the applicant, including insurance fees. It must refund to the applicant any fees that SBA considers excessive. Failure to do so may result in an action by SBA to suspend or revoke the Lender's participation status.

(b) An applicant for a business loan must certify to SBA the name of each individual or entity (attorney, loan packager, broker, accountant, Service Provider, Lender) that helped the applicant obtain the loan, describing the services performed, and disclosing the amount of each fee.

**Subpart B—Policies Specific to 7(a) Loans****Bonding Requirements****§ 120.200 What bonding requirements exist during construction?**

On 7(a) loans where the SBA guarantee covers a period of construction, the Borrower must supply a 100 percent payment and performance bond and builder's risk insurance, unless waived by SBA.

**Limitations on Use of Proceeds****§ 120.201 Refinancing unsecured or undersecured loans.**

A Borrower may not use 7(a) loan proceeds to pay off an inadequately secured creditor, including a Lender, causing a shift to SBA of all or part of a potential loss from an existing debt.

**§ 120.202 Restrictions on loans for changes in ownership.**

A Borrower may not use loan proceeds to purchase a portion of a business or a portion of another owner's interest. One or more current owners may use loan proceeds to purchase the entire interest of another current owner, or a Borrower can purchase ownership of an entire business.

**§ 120.203 Revolving credit.**

SBA may not use its regular 7(a) program for a revolving line of credit, such as "floor plan" financing. (See § 120.390 for special Caplines program.)

Maturities; Interest Rates; Loan and Guarantee Amounts

**§ 120.210 What percentage of a loan may SBA guarantee?**

SBA's guarantee percentage must not exceed the applicable percentage established in section 7(a) of the Act. The maximum allowable guarantee percentage on a loan will be determined by the *loan amount*. As of October 31, 1995, the percentages are: Loans of \$100,000 or less may receive a maximum guarantee of 80 percent. All other loans may receive a maximum guarantee of 75 percent, not to exceed \$750,000.

**§ 120.211 What limits are there on the amounts of direct loans?**

(a) The statutory limit for direct loans made under the authority of section 7(a)(1)–(19) of the Small Business Act is \$350,000. SBA has established an administrative limit of \$150,000 for direct loans. The Associate Administrator for Financial Assistance (AA/FA) may authorize acceptance of an application up to the statutory limit.

(b) The statutory limit for direct loans made under the authority of section 7(a)(20) is \$750,000. SBA has established an administrative limit of \$150,000. The Associate Administrator for Minority Enterprise Development may authorize the acceptance of an application that exceeds the administrative limit.

(c) The statutory limit on SBA's portion of an immediate participation loan is the lesser of 90 percent of the loan or \$350,000. The administrative limit is the lesser of 75 percent of the loan or \$150,000. The AA/FA may authorize exceptions to the administrative limit up to \$350,000.

**§ 120.212 What limits are there on loan maturities?**

The term of a loan shall be:

(a) The shortest appropriate term, depending upon the Borrower's ability to repay;

(b) Ten years or less, unless it finances or refinances real estate or equipment with a useful life exceeding ten years; and

(c) A maximum of 25 years, including extensions. (A portion of a loan used to acquire or improve real property may have a term of 25 years plus an additional period needed to complete the construction or improvements.)

**§ 120.213 What fixed interest rates may a Lender charge?**

(a) *Fixed Rates for Guaranteed Loans.* A loan may have a reasonable fixed interest rate. SBA periodically publishes the maximum allowable rate in the Federal Register.

(b) *Direct loans.* A statutory formula based on the cost of money to the Federal government determines the interest rate on direct loans. SBA publishes the rate periodically in the Federal Register.

**§ 120.214 What conditions apply for variable interest rates?**

A Lender may use a variable rate of interest, upon SBA's approval. SBA's maximum allowable rates apply only to the initial rate on the date SBA received the loan application. SBA shall approve the use of a variable interest rate under the following conditions:

(a) *Frequency.* The first change may occur on the first calendar day of the month following initial disbursement,

using the base rate (see paragraph (c) of this section) in effect on the first business day of the month. After that, changes may occur no more often than monthly.

(b) *Range of fluctuation.* The amount of fluctuation shall be equal to the movement in the base rate. The difference between the initial rate and the ceiling rate may be no greater than the difference between the initial rate and the floor rate.

(c) *Base rate.* The base rate shall be the prime rate in effect on the first business day of the month, printed in a national financial newspaper published each business day, or the SBA Optional Peg Rate which SBA publishes quarterly in the Federal Register.

(d) *Maturities under 7 years.* For loans with maturities under seven years, the maximum interest rate shall not exceed two and one-quarter (2¼) percentage points over the base rate.

(e) *Maturities of 7 years or more.* For loans with maturities of seven or more

years, the maximum interest rate shall not exceed two and three-quarters (2¾) percentage points over the base rate.

(f) *Higher interest rates for smaller loans.* For a variable rate loan over \$25,000 but not exceeding \$50,000, the interest rate may be one percent more than the maximum interest rate described above. For a variable rate loan of \$25,000 or less, the maximum interest rate described above may be increased by two percentage points.

(g) *Amortization.* Initial amortization of principal and interest may be recomputed as interest rates fluctuate, as directed by SBA. With prior approval of SBA, the Lender may use certain other amortization methods.

**Fees for Guaranteed Loans**

**§ 120.220 Guarantee fees that Lender pays SBA.**

(a) The Lender pays a guarantee fee to SBA for each loan as follows:

Guaranteed portion of loan	Fee measured as percentage of guaranteed portion	When payable	Lender may get fee from borrower	When SBA refunds fee from borrower
Under 12 months .....	.25% .....	With guarantee application.	When SBA approves loan.	If application withdrawn or denied <sup>1</sup>
More than 12 months and total guaranteed portion is \$80,000 or less.	2.0% of guaranteed portion.	Within 90 days of SBA approval.	After First disbursement.	If loan cancelled and never disbursed
More than 12 months and amount of guaranteed portion of loan that is \$250,000 or less.	3% .....	Within 90 days of SBA approval.	After first disbursement.	If loan cancelled and never disbursed
More than 12 months and amount of guaranteed portion of loan between \$250,000 and \$500,000.	3.0% of 1st \$250,000 plus 3.5% of balance.	Within 90 days of SBA approval.	After first disbursement.	If loan cancelled and never disbursed
More than 12 months and amount of guaranteed portion of loan exceeding \$500,000.	3.0% of 1st \$250,000 plus 3.5% of next \$250,000 plus 3.875% of the amount exceeding \$500,000.	Within 90 days of SBA approval.	After first disbursement.	If loan cancelled and never disbursed.

<sup>1</sup> Also, if SBA substantially changes the Lender's loan terms and approves the loan, but the modified terms are unacceptable to the Borrower or Lender. (The Lender must request refund in writing within 30 calendar days of the approval).

(b) The Lender shall also pay SBA an annual fee equal to 0.5 percent of the outstanding balance of the guaranteed portion of each loan.

(c) If the guarantee fee is not paid, SBA may terminate the guarantee. The Borrower may use loan proceeds to reimburse the Lender for the guarantee fee. Acceptance of the guarantee fee by SBA shall not waive any right of SBA arising from the Lender's misconduct or violation of any provision of this part, the guarantee agreement, the Authorization, or other loan documents.

**§ 120.221 Fees which the Lender may collect from a loan applicant.**

(a) *Service and packaging fees.* The Lender may charge an applicant reasonable fees (customary for similar Lenders in the geographic area where the loan is being made) for packaging and other services. The Lender must advise the applicant in writing that the applicant is not required to obtain or pay for unwanted services. The applicant is responsible for deciding whether fees are reasonable. SBA may review these fees at any time. Lender must refund any such fee considered unreasonable by SBA.

(b) *Commitment fee for Export Working Capital loan.* After SBA approves a loan under the Export Working Capital Program, the Lender may charge the borrower a commitment fee of ¼ of 1 percent (or \$200 minimum) of the loan.

(c) *Extraordinary servicing.* Subject to prior written SBA approval, if all or part of a loan will have extraordinary servicing needs, the Lender may charge the applicant a service fee not to exceed 2 percent per year on the outstanding balance of the part requiring special servicing.

(d) *Out-of-pocket expenses.* The Lender may collect from the applicant

necessary out-of-pocket expenses such as filing or recording fees.

(e) *Late payment fee.* The Lender may charge the Borrower a late payment fee not to exceed 5 percent of the regular loan payment.

(f) *No prepayment fee.* The Lender may not charge a fee for full or partial prepayment of a loan.

**§ 120.222 Fees which the Lender or Associate may not collect from the Borrower or share with third parties.**

The Lender or its Associate may not:

(a) Require the applicant or Borrower to pay the Lender, an Associate, or any party designated by either, any fees or charges for goods or services, including insurance, as a condition for obtaining an SBA guaranteed loan (unless permitted by this part);

(b) Charge an applicant any commitment, bonus, broker, commission, or similar fee;

(c) Charge points or add-on interest;

(d) Share any premium received from the sale of an SBA guaranteed loan in the secondary market with either a packager or other loan-referral source; or

(e) Charge the Borrower for legal services, unless they are hourly charges for requested services actually rendered.

**Subpart C—Special Purpose Loans**

**§ 120.300 Statutory authority.**

In addition to the general 7(a) business loan program, Congress has authorized several special purpose programs in various subsections of the Act. Generally, the regular 7(a) loan policies, eligibility requirements and credit criteria apply. The sections of this subpart prescribe the special conditions applying to each special purpose program. As with other business loans, special purpose loans are available only to the extent funded by annual appropriations.

Disabled Assistance Loan Program (DAL)

**§ 120.310 What assistance is available for the disabled?**

Section 7(a)(10) of the Act authorizes SBA to guarantee or make direct loans to the disabled. SBA distinguishes two kinds of assistance:

(a) *DAL-1.* DAL-1 Financial Assistance is available to non-profit public or private organizations for the disabled that employ the disabled; or

(b) *DAL-2.* DAL-2 Financial Assistance is available to:

(1) Small businesses wholly owned by the disabled; and

(2) Disabled individuals to establish, acquire, or operate a small business.

**§ 120.311 Definitions.**

(a) *Organization for the disabled* means one which:

(1) Is organized under federal or state law to operate in the interest of the disabled;

(2) Is non-profit;

(3) Employs disabled individuals for seventy-five percent of the time needed to produce commodities or services for sale; and

(4) Complies with occupational and safety standards prescribed by the Department of Labor.

(b) *Disabled individual* means a person who has a permanent physical, mental or emotional impairment, defect, ailment, disease or disability which limits the type of employment for which the person would otherwise be qualified.

**§ 120.312 DAL-1 use of proceeds and other program conditions.**

(a) DAL-1 applicants must submit appropriate documents to establish program eligibility.

(b) Generally, applicants may use loan proceeds for any 7(a) loan purposes. Loan proceeds may not be used:

(1) To purchase or construct facilities if construction grants and mortgage assistance are available from another Federal source; or

(2) For supportive services (expenses incurred by a DAL-1 organization to subsidize wages of low producers health and rehabilitation services, management, training, education, and housing of disabled workers).

(c) SBA does not consider a DAL-1 organization to have a conflict of interest if one or more of its Associates is an Associate of the Lender.

**§ 120.313 DAL-2 use of proceeds and other program conditions.**

(a) The DAL-2 loan proceeds may be used for normal 7(a) loan purposes.

(b) An applicant may use DAL-2 loan proceeds to acquire an eligible small business without complying with the change of ownership conditions in § 120.206.

(c) A DAL-2 applicant must submit evidence from a physician, psychiatrist, or other qualified professional as to the permanent nature of the disability and the limitation it places on the applicant.

**§ 120.314 Resolving doubts about creditworthiness.**

For the purpose of the DAL Program, SBA shall resolve doubts concerning the creditworthiness of an applicant in favor of the applicant. However, the applicant must present satisfactory evidence of repayment ability. Personal guarantees of Associates are not required.

**§ 120.315 Interest rate and loan limit.**

The interest rate on direct DAL loans is three percent. There is an administrative limit of \$150,000 on a direct DAL loan.

Businesses Owned by Low Income Individuals

**§ 120.320 Policy.**

Section 7(a)(11) of the Act authorizes SBA to make or guarantee loans to establish, preserve or strengthen small business concerns:

(a) Located in an area having high unemployment according to the Department of Labor;

(b) Located in an area in which a high percentage of individuals have a low income inadequate to satisfy basic family needs; and

(c) More than 50 percent owned by low income individuals.

Energy Conservation

**§ 120.330 Who is eligible for an energy conservation loan?**

SBA may make or guarantee loans to assist a small business to design, engineer, manufacture, distribute, market, install, or service energy devices or techniques designed to conserve the Nation's energy resources.

**§ 120.331 What devices or techniques are eligible for a loan?**

Eligible energy conservation devices or techniques include:

(a) Solar thermal equipment;

(b) Photovoltaic cells and related equipment;

(c) A product or service which increases the energy efficiency of existing equipment, methods of operation or systems which use fossil fuels, and which is on the Energy Conservation Measures list of the Secretary of Energy;

(d) Equipment producing energy from wood, biological waste, grain or other biomass energy sources;

(e) Equipment for cogeneration of energy, district heating or production of energy from industrial waste;

(f) Hydroelectric power equipment;

(g) Wind energy conversion equipment; and

(h) Engineering, architectural, consulting, or other professional services necessary or appropriate for any of the devices or techniques in paragraphs (a) through (g) of this section.

**§ 120.332 What are the eligible uses of proceeds?**

(a) *Acquire property.* The Borrower may use the loan proceeds to acquire land necessary for imminent plant construction, buildings, machinery,

equipment, furniture, fixtures, facilities, supplies, and material needed to accomplish any of the eligible program purposes in § 120.330.

(b) *Research and development.* Up to 30% of loan proceeds may be used for research and development:

(1) Of an existing product or service; or

(2) A new product or service.

(c) *Working capital.* The Borrower may use proceeds for working capital for entering or expanding in the energy conservation market.

**§ 120.333 Are there any special credit criteria?**

In addition to regular credit evaluation criteria, SBA shall weigh the greater risk associated with energy projects. SBA shall consider such factors as quality of the product or service, technical qualifications of the applicant's management, sales projections, and financial status.

Export Working Capital Program (EWCP)

**§ 120.340 What is the Export Working Capital Program?**

Under the EWCP, SBA guarantees a revolving line of credit for export purposes (section 7(a)(14) of the Act). Loan maturities may be for up to three years with annual renewals. Proceeds can be used only to finance export transactions. Loans can be for single or multiple export sales.

**§ 120.341 Who is eligible?**

In addition to the criteria applicable to all 7(a) loans, an applicant must be in business for one full year at the time of application, but not necessarily in the exporting business. SBA may waive this requirement if the applicant has sufficient export trade experience or other managerial experience.

**§ 120.342 What are eligible uses of proceeds?**

Loan proceeds may be used:

- (a) To acquire inventory;
- (b) To pay the manufacturing costs of goods for export;
- (c) To purchase goods or services for export;
- (d) To support standby letters of credit;
- (e) To develop or penetrate foreign markets;
- (f) For pre-shipment working capital; and
- (g) For post-shipment exposure coverage.

**§ 120.343 Collateral.**

A Borrower must give SBA a first security interest sufficient to cover 100

percent of the EWCP loan amount (such as insured accounts receivable or letters of credit). Collateral must be located in the United States, its territories or possessions.

**§ 120.344 Cash flow projections.**

An applicant must submit cash flow projections to support the need for the loan and the ability to repay. After the loan is made, the loan recipient must submit monthly progress reports.

International Trade Loans

**§ 120.345 Policy.**

Section 7(a)(16) of the Act authorizes SBA to guarantee loans to small businesses that are:

(a) Engaged or preparing to engage in international trade; or

(b) Adversely affected by import competition.

**§ 120.346 Eligibility.**

(a) An applicant must establish that:

(1) The loan proceeds will significantly expand an existing export market or develop new export markets; or

(2) The applicant business is adversely affected by import competition; and

(3) Upgrading facilities or equipment will improve the applicant's competitive position.

(b) The applicant must have a business plan reasonably supporting its projected export sales.

**§ 120.347 Use of proceeds.**

The Borrower may use loan proceeds to acquire, construct, renovate, modernize, improve, or expand facilities and equipment to be used in the United States to produce goods or services involved in international trade.

**§ 120.348 Amount and percentage of guarantee.**

SBA can guarantee up to \$1,250,000 for a combination of fixed-asset financing and working capital, supplies and EWCP assistance. The non-fixed-asset portion cannot exceed \$750,000.

Qualified Employee Trusts (ESOP)

**§ 120.350 Policy.**

Section 7(a)(15) of the Act authorizes SBA to guarantee a loan to a qualified employee trust ("ESOP") to:

(a) Help finance the growth of its employer's small business; or

(b) Purchase ownership or voting control of the employer.

**§ 120.351 Definitions.**

All terms specific to ESOPs have the same definition for purposes of this section as in the Internal Revenue

Service (IRS) Code (title 26 of the United States Code) or regulations (26 CFR chapter I).

**§ 120.352 Use of proceeds.**

Loan proceeds may be used for two purposes.

(a) *Qualified employer securities.* A qualified employee trust may relend loan proceeds to the employer by purchasing qualified employer securities. The small business concern may use these funds for any general 7(a) purpose.

(b) *Control of employer.* A qualified employee trust may use loan proceeds to purchase a controlling interest (51 percent) in the employer. Ownership and control must vest in the trust by the time the loan is repaid.

**§ 120.353 Eligibility.**

SBA may assist a qualified employee trust (or equivalent trust) that meets the requirements and conditions for an ESOP prescribed in all applicable IRS, Treasury and DOL regulations. In addition, the following conditions apply:

(a) The small business must provide the funds needed by the trust to repay the loan; and

(b) The small business must provide adequate collateral.

**§ 120.354 Creditworthiness.**

In determining repayment ability, SBA shall not consider the personal assets of the employee-owners of the trust. SBA shall consider the earnings history and projected future earnings of the employer small business. SBA may consider the business and management experience of the employee-owners. SBA must have evidence that financial assistance is not otherwise available by utilizing:

(a) The personal resources and credit of the principals of the small business;

(b) The resources and credit of the small business; or

(c) The sale of the assets of the small business.

Veterans Loan Program

**§ 120.360 Which veterans are eligible?**

SBA may make a direct loan to a small business 51 percent owned by one or more of the following eligible veterans:

(a) Vietnam-era veterans who served for a period of more than 180 days between August 5, 1964, and May 7, 1975, and were discharged other than dishonorably;

(b) Disabled veterans of any era with a minimum compensable disability of 30 percent; or

(c) A veteran of any era who was discharged for disability.

**§ 120.361 Other conditions of eligibility.**

(a) Management and daily operations of the business must be directed by one or more of the veteran owners whose veteran status was used to qualify for the loan.

(b) This direct loan program is available only if private sector financing and guaranteed loans are not available.

(c) A veteran may qualify only once for this direct loan program.

Pollution Control Program

**§ 120.370 Policy.**

Section 7(a)(12) of the Act authorizes SBA to guarantee loans up to \$1,000,000 to an eligible small business to plan, design or install a pollution control facility. An applicant must meet the eligibility requirements for 7(a) loans.

Loans to Participants in the 8(a) Program

**§ 120.375 Policy.**

Section 7(a)(20) of the Act authorizes SBA to provide direct (unilaterally or together with Lenders) or guaranteed loans to firms participating in the 8(a) Program.

**§ 120.376 Special requirements.**

The following special conditions apply (otherwise, the general 7(a) eligibility criteria apply):

(a) The Associate Administrator of Minority Enterprise Development ("MED") may waive the direct loan administrative ceiling of \$150,000, and raise it to \$750,000.

(b) The SBA portion on a guaranteed loan must not exceed \$750,000.

(c) The interest rate on a guaranteed loan shall be the same as on regular 7(a) guarantee loans. The interest rate on a direct loan shall be one percent less than on a regular direct loan.

(d) For a direct loan or SBA's portion of an immediate participation loan, SBA shall subordinate its security interest on all collateral to other debt of the applicant.

**§ 120.377 Use of proceeds.**

The loan proceeds shall not be used for debt refinancing. A manufacturing concern may use loan proceeds for working capital.

Defense Economic Transition Assistance

**§ 120.380 Program.**

Section 7(a)(21) of the Act authorizes SBA to guarantee loans to help eligible small businesses transition from defense to civilian markets, or eligible individuals adversely impacted by base closures or defense cutbacks to acquire or open and operate a small business.

**§ 120.381 Eligibility.**

(a) *Eligible small businesses.* A small business is eligible if it has been detrimentally impacted by the closure (or substantial reduction) of a Department of Defense installation, or the termination (or substantial reduction) of a Department of Defense Program on which the small business was a prime contractor, subcontractor, or supplier at any tier.

(b) *Eligible individual.* An eligible individual, for purposes of this program, includes the following persons involuntarily separated from their position or voluntarily terminated under a program offering inducements to encourage early retirement:

(1) A member of the Armed Forces of the United States (honorably discharged);

(2) A civilian employee of the Department of Defense; or

(3) An employee of a prime contractor, sub-contractor, or supplier at any tier of a Department of Defense program.

**§ 120.382 Repayment ability.**

SBA shall resolve reasonable doubts concerning the small business' proposed business plan for transition to non-defense-related markets in favor of the loan applicant in determining the sound value of the proposed loan.

**§ 120.383 Restrictions on loan processing.**

Since greater risk may be associated with a loan to an applicant under this program, a Certified Lender or Preferred Lender shall not make a defense economic assistance loan.

CapLines Program

**§ 120.390 Revolving credit.**

CapLines finances small businesses' short-term, revolving working-capital needs. Generally, SBA regulations governing the 7(a) program also govern this program. Under CapLines, SBA generally can guarantee up to \$750,000.

Small General Contractors

**§ 120.391 What is the Small General Contractor Program?**

SBA may make or guarantee loans to finance small general contractors to construct or rehabilitate residential or commercial property for resale (section 7(a)(9) of the Act). This program provides an exception under specified conditions to the general rule against financing investment property. "Construct" and "rehabilitate" mean only work done on-site to the structure, utility connections and landscaping.

**§ 120.392 Who may apply?**

A construction contractor or home-builder with a past history of profitable construction or rehabilitation projects of comparable type and size may apply. An applicant may subcontract a portion of the work. Subcontracts in excess of \$25,000 may require 100 percent payment and performance bonds.

**§ 120.393 Are there special application requirements?**

(a) An applicant must submit letters from:

(1) A mortgage lender indicating that permanent mortgage money is available to qualified purchasers to buy such properties;

(2) A real estate broker indicating that a market exists for the proposed building and that it will be compatible with its neighborhood; and

(3) An architect, appraiser or engineer agreeing to make inspections and certifications to support interim disbursements.

(b) The Borrower may substitute a letter from a Lender for one or more of the letters.

**§ 120.394 What are the eligible uses of proceeds?**

A Borrower must use the loan proceeds solely to acquire, construct or substantially rehabilitate an individual residential or commercial building for sale. "Substantial" means rehabilitation expenses of more than one-third of the purchase price or fair market value at the time of the application. A Borrower may use up to 20 percent of the proceeds to acquire land, and up to 5 percent for community improvements such as curbs and sidewalks.

**§ 120.395 What is SBA's collateral position?**

SBA will require a lien on the building which must be in no less than a second position.

**§ 120.396 What is the term of the loan?**

The loan must not exceed thirty-six months plus the estimated time to complete construction or rehabilitation.

**§ 120.397 Are there any special restrictions?**

The borrower must not use loan proceeds to purchase vacant land for possible future construction or to operate or hold rental property for future rehabilitation. SBA may allow rental of the property only if the rental will improve the ability to sell the property. The sale must be a legitimate change of ownership.

**Subpart D—Lenders****§ 120.400 Participation agreements.**

SBA may enter into participation agreements with Lenders to make deferred participation (guaranteed) loans. Participation agreements do not obligate SBA to participate in any specific proposed loan that a Lender may submit. The existence of a participation agreement does not limit SBA's rights to deny a specific loan or establish general policies.

**Participation Criteria****§ 120.410 Requirements for all participating Lenders.**

A Lender must:

- (a) Have a continuing ability to evaluate, process, close, disburse, and service small business loans;
- (b) Be open to the public for the making of such loans (not be a financing subsidiary, engaged primarily in financing the operations of an affiliate);
- (c) Have continuing good character and reputation, and otherwise meet and maintain the ethical requirements of § 120.140; and
- (d) Be supervised and examined by a State or Federal regulatory authority, satisfactory to SBA.

**§ 120.411 Preferences.**

No agreement to participate under the Act shall establish any Preferences in favor of the Lender.

**§ 120.412 Other services Lenders may provide Borrowers.**

Subject to the conflict of interest provision in subpart A of this part, Lenders, their Associates or the designees of either may provide services to and contract for goods with a Borrower only after full disbursement of the loan to the small business or to an account not controlled by the Lender, its Associate, or the designee. A Lender, an Associate, or a designee providing such services must do so under a written contract with the small business, based on time and hourly charges, and must maintain time and billing records for examination by SBA. Charges made cannot exceed those charged by established professional consultants providing similar services.

**§ 120.413 Advertisement of relationship with SBA.**

A Lender may refer in its advertising to its participation with SBA. The advertising may not:

- (a) State or imply that the Lender, or any of its Borrowers, has or will receive preferential treatment from SBA;
- (b) Be false or misleading; or
- (c) Make use of SBA's seal.

**Pledging Notes or Transferring Unguaranteed Portion****§ 120.420 Financings by Nondepository Lenders.**

(a) A Small Business Lending Company regulated by SBA or a Business and Industrial Development Company ("Nondepository Lender") may pledge the notes evidencing SBA guaranteed loans or sell the unguaranteed portions of such loans if SBA, in its sole discretion, gives its prior written consent. The Lender must be secure financially and have a history of compliance with SBA's regulations and any other applicable state or Federal statutory and regulatory requirements.

(b) The Nondepository Lender, SBA, and any third party involved in the transaction, as determined by SBA in its sole discretion, must enter into a written agreement satisfactory to SBA acknowledging SBA's interest as guarantor of the subject loans and accepting that all relevant third parties agree to recognize and uphold those interests under the Act, this part, and the contractual provisions of SBA's blanket Guarantee Agreement. In any such agreement, the parties must agree to the following conditions:

(1) The Nondepository Lender, SBA, or a third party custodian agreeable to SBA, will hold all pertinent Loan Instruments, and the Nondepository Lender will continue to service the loans after the pledge or transfer is made;

(2) The Nondepository Lender must continue to retain an economic risk in and bear the ultimate risk of loss on the unguaranteed portions. The Nondepository Lender must demonstrate to SBA's satisfaction and in SBA's sole discretion the retention of economic risk by:

- (i) In the case of the sale of unguaranteed portions:
  - (A) Establishing a sufficient reserve fund at time of sale;
  - (B) Retaining a sufficient level of insurance; and/or
  - (C) Agreeing to reacquire the unguaranteed portion of a guaranteed loan or the note evidencing a guaranteed loan if the loan goes into default; or
- (ii) In the case of the pledge of notes, retaining all of the economic interest in the unguaranteed portion of any loans which the notes evidence.

(c) The Nondepository Lender may not use SBA guaranteed loans or the collateral supporting such loans as collateral for the borrowing of any related enterprise or for any other purpose inconsistent with this part.

**Miscellaneous Provisions****§ 120.430 SBA access to Lender files.**

A Lender must allow SBA's authorized representatives, during normal business hours, access to its files to review, inspect and copy all records and documents relating to SBA guaranteed loans.

**§ 120.431 Suspension and revocation of eligibility to participate.**

SBA may suspend or revoke the eligibility of a Lender to participate in the 7(a) program because of a violation of SBA regulations, a breach of any agreement with SBA, a change of circumstance resulting in the Lender's inability to meet operational requirements, or a failure to engage in prudent lending practices. Proceedings for such purposes will be conducted in accordance with the provisions of part 134 of this chapter. A suspension or revocation will not invalidate a guarantee previously provided by SBA.

**Certified Lenders Program (CLP)****§ 120.440 What is the Certified Lenders Program?**

Under the Certified Lenders Program (CLP), designated Lenders process, close, and service, and may liquidate, SBA guaranteed loans. SBA gives priority to applications and servicing actions submitted by Lenders under this program. All other rules in this part 120 relating to the operations of Lenders apply to CLP Lenders.

**§ 120.441 How does a Lender become a CLP Lender?**

(a) An SBA field office may nominate a Lender or a Lender may request a field office to consider it for CLP status. SBA district directors may approve and renew a Lender's CLP status. The district director will consider whether the Lender:

- (1) Has the ability to process, close, service and liquidate loans; and
- (2) Has a satisfactory performance history with SBA, including the submission of complete and accurate loan guarantee application packages;
- (3) Has an acceptable SBA purchase rate; and
- (4) Has shown the ability to work well with the local SBA office.

(b) If the district director does not approve a request for CLP status, the Lender may appeal to the AA/FA, whose decision will be final. If SBA grants CLP status, it applies only in the field office that approved the CLP designation. A CLP Lender must execute a Supplemental Guarantee Agreement that will specify a term not to exceed two years.

**§ 120.442 Suspension or revocation of CLP status.**

The AA/FA may suspend or revoke CLP status upon written notice providing the reasons at least 10 business days prior to the effective date of the suspension or revocation. Reasons for suspension or revocation may include a loan performance record unacceptable to SBA, failure to make the required number of loans under the expedited procedures, or violations of applicable statutes, regulations or published SBA policies and procedures. A CLP Lender may appeal the suspension or revocation made under this section under procedures found in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

Preferred Lenders Program (PLP)

**§ 120.450 What is the Preferred Lenders Program?**

Under the Preferred Lenders Program (PLP), designated Lenders process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation to and prior approval by SBA.

**§ 120.451 How does a Lender become a PLP Lender?**

(a) An SBA field office serving the area where a CLP Lender's office is located can nominate a CLP Lender or a CLP Lender can request a field office to consider it for PLP status. The SBA field office will forward its recommendation to an SBA centralized loan processing center which will submit its recommendation and supporting documentation to the AA/FA for final decision.

(b) In making its decision, SBA will consider whether the CLP Lender:

- (1) Has the required ability to process, close, service and liquidate loans; and
- (2) Has the ability to develop and analyze complete loan packages; and
- (3) Has a satisfactory performance history with SBA.

(c) If the Lender is approved, the AA/FA will designate the area in which it can make PLP loans.

(d) Before it can operate as a PLP Lender, the approved CLP Lender must execute a Supplemental Loan Guarantee Agreement, which will specify a term not to exceed two years.

(e) When a PLP's Supplemental Loan Guarantee Agreement expires, SBA may recertify it as a PLP Lender for an additional term not to exceed two years. Prior to recertification, SBA will review a PLP Lender's loans, policies and procedures. The recertification decision of the AA/FA is final.

(f) A PLP Lender may request an expansion of the territory in which it can process PLP loans by submitting its request to a loan processing center. The center shall obtain the recommendation of each SBA office in the area into which the PLP Lender would like to expand its PLP operations. The center shall forward the recommendations to the AA/FA for final decision. If a PLP Lender is not already a CLP Lender in a territory into which it seeks to expand its PLP status, it will automatically obtain CLP status in the territory without approval from the District Office when it is granted its extension of PLP status into that territory.

**§ 120.452 What are the requirements of PLP loan processing?**

(a) Subparts A and B of this part govern the making of PLP loans, except for the following:

(1) Certain types of businesses, loans, and loan programs are not eligible for PLP, as detailed in published SBA policy and procedures.

(2) A Lender may not use the PLP procedure to reduce its existing credit exposure for any Borrower.

(3) SBA will guarantee no more than the specified statutory percentage of any PLP loan. (b) A PLP Lender notifies SBA of its approval of a PLP loan by submitting to SBA's loan processing center appropriate documentation signed by two of the PLP's authorized representatives. SBA will attach the SBA guarantee and notify the PLP Lender of the SBA Loan Number (if it does not identify a problem with eligibility, and funds are available).

(c) The PLP Lender is responsible for the correctness of all PLP loan decisions regarding eligibility (including size), creditworthiness, loan closing, and compliance with all requirements of law or SBA regulations.

**§ 120.453 What are the requirements of PLP loan servicing and liquidation?**

The PLP Lender must service and liquidate its SBA guaranteed loan portfolio (including its non-PLP loans) using generally accepted commercial banking standards employed by prudent lenders. The PLP Lender must liquidate any defaulted SBA guaranteed loan in its portfolio unless SBA advises in writing that SBA will liquidate the loan. The PLP Lender must submit a liquidation plan to SBA prior to commencing liquidation action, if possible. The PLP Lender may take any necessary servicing action, or liquidation action consistent with a plan, for any SBA guaranteed loan in its portfolio, except it may not:

(a) Take any action that confers a Preference on the Lender;

(b) Accept a compromise settlement without prior written SBA consent; and

(c) Sell or pledge more than 90 percent of a PLP loan.

**§ 120.454 PLP performance review.**

SBA may review the performance of a PLP Lender. SBA may charge the PLP Lender a fee for this review.

**§ 120.455 Suspension or revocation of PLP status.**

The AA/FA may suspend or revoke PLP status upon written notice providing the reasons at least 10 business days prior to the effective date of the suspension or revocation. Reasons for suspension or revocation may include loan performance unacceptable to SBA, failure to make the required number of loans under the expedited procedures, or violations of applicable statutes, regulations or published SBA policies and procedures. A PLP Lender may appeal the suspension or revocation made under this section under procedures found in Part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

Small Business Lending Companies (SBLC)

**§ 120.470 What is an SBLC?**

A Small Business Lending Company (SBLC) is a nondepository lending institution engaged solely in the making of loans under section 7(a) (except section 7(a)(13)) of the Act in participation with SBA. SBA supervises, examines, and regulates SBLCs. An SBLC is subject to all applicable SBA regulations, including those governing Lenders. This program has been closed to new licenses since January, 1982. In addition to complying with § 120.400-120.413, an SBLC must meet the following requirements:

(a) *Business structure.* It must be a corporation (profit or non-profit).

(b) *Written agreement.* It must sign a written agreement with SBA with terms satisfactory to SBA.

(c) *Capital structure.* It must have unencumbered paid-in capital and paid-in surplus of at least \$1,000,000, or ten percent of the aggregate of its share of all outstanding loans, whichever shall be more.

(d) *Capital impairment.* It must avoid capital impairment at all times. Impairment exists if the retained earnings deficit of an SBLC exceeds 50 percent of combined paid-in capital and paid-in-surplus, excluding treasury stock. An SBLC must give SBA prompt written notice of any capital impairment

within 30 calendar days of the month-end financial report that first reflects the impairment. Until the impairment is cured, an SBLC may not present any loans to SBA for guarantee.

(e) *Issuance of securities.* Without prior written SBA approval, it must not issue any securities (including stock options and debt securities) except stock dividends and common stock issued for cash or direct obligations of, or obligations fully guaranteed as to principal and interest by, the United States.

(f) *Voluntary capital reduction.* Without prior written SBA approval, it must not voluntarily reduce its capital, or purchase and hold more than 2 percent of any class or combination of classes of its stock.

(g) *Reserves for losses.* It must maintain a reserve in the amount of anticipated losses on loans and receivables.

(h) *Internal control.* It must adopt a plan designed to safeguard its funds and other assets, to assure the reliability of its personnel, and to maintain the accuracy of its financial data.

(i) *Dual control.* It must maintain dual control over disbursement of funds and withdrawal of securities. An SBLC may disburse funds only by checks or wire transfers authorized by signatures of two or more officers covered by the SBLC's fidelity bond, except that checks in an amount of \$1,000 or less may be signed by one bonded officer. There must be two or more bonded officers, or one bonded officer and a bonded employee to open safe deposit boxes or withdraw securities from safekeeping. The SBLC shall furnish to each depository bank, custodian, or entity providing safe deposit boxes a certified copy of the resolution implementing these control procedures.

(j) *Fidelity insurance.* It must maintain a Brokers Blanket Bond, Standard Form 14, or Finance Companies Blanket Bond, Standard Form 15, or such other form of coverage as SBA may approve, in a minimum amount of \$25,000 executed by a surety holding a Certificate of authority from the Secretary of the Treasury pursuant to 6 U.S.C. 6-13.

(k) *Common control.* It must not control, be controlled by, or under common control with, another SBLC. Without prior written SBA approval, an Associate of one SBLC shall not be an Associate of another SBLC or of any entity which directly or indirectly controls or is under common control with another SBLC.

(l) *Management services.* An SBLC must employ full time professional management.

(m) *Borrowed funds.* Without SBA's prior written approval, it must not be capitalized with borrowed funds. Shareholders owning 10 percent or more of any class of its stock shall not use borrowed funds to purchase the stock unless the net worth of the shareholders is at least twice the amount borrowed or unless the shareholders receive SBA's prior written approval for a lower ratio.

#### § 120.471 Records.

Each SBLC must comply with the following requirements concerning records:

(a) *Maintenance of Records.* It must maintain accurate and current financial records, including books of account, minutes of stockholder, directors, or executive committee meetings, and all documents and supporting materials relating to the SBLC's transactions at its principal business office. Securities held by a custodian pursuant to a written agreement shall be exempt from this requirement.

(b) *Preservation of records.*

(1) It must preserve in a manner permitting immediate retrieval the following documentation for the financial statements required by § 120.472 (and of the accompanying independent public accountant's opinion), for the following specified periods:

(i) Preserve permanently:

(A) All general and subsidiary ledgers (or other records) reflecting asset, liability, capital stock and surplus, income, and expense accounts;

(B) All general and special journals (or other records forming the basis for entries in such ledgers); and

(C) The corporate charter, bylaws, application for determination of eligibility to participate with SBA, and all minutes books, capital stock Certificates or stubs, stock ledgers, and stock transfer registers;

(ii) Preserve for at least 6 years following final disposition of the related loan:

(A) All applications for financing;

(B) Lending, participation, and escrow agreements;

(C) Financing instruments; and

(D) All other documents and supporting material relating to such loans, including correspondence.

(2) Records and other documents referred to in this section may be preserved electronically or by reproduction if the SBLC makes and stores duplicate originals separately from the original for the time required.

#### § 120.472 Reports to SBA.

An SBLC must submit the following to the AA/FA:

(a) An audited financial statement prepared by an independent public accountant within three months after the close of each fiscal year, and interim financial reports when requested by SBA;

(b) A report of any legal or administrative proceeding, by or against the SBLC, or against an officer, director, or employee of the SBLC for an alleged breach of official duty, within 10 days after initiating or learning of the proceeding, as well as notification of the terms of any settlement or final judgment (in addition to any reporting under applicable SBA Forms);

(c) Copies of any report furnished to its stockholders (including any prospectus, letter, or other publication concerning the financial operations of the SBLC);

(d) A summary of any changes in the SBLC's organization or financing, such as:

(1) Any change in its name, address or telephone number;

(2) Any change in its charter, bylaws, or its officers or directors (to be accompanied by a statement of personal history on an approved SBA form);

(3) Any changes in capitalization not otherwise required by § 120.470 to be reported to SBA;

(4) Any changes affecting the eligibility of the SBLC to continue to participate as an SBLC; and

(5) Notice of a pledge of stock within 30 calendar days of the transaction if 10 percent or more of the stock is pledged by any person (or group of persons acting in concert) as collateral for indebtedness, and such pledge does not involve a transfer for which prior written approval of SBA is required under § 120.473; and

(e) Such other reports as SBA may require from time to time by written directive.

#### § 120.473 Change of ownership or control.

(a) Any change of ownership or control without prior written approval of SBA is prohibited. An SBLC must request approval of any such change from the AA/FA. Pending the approval, the SBLC may not register the proposed new owners on its transfer books nor permit them to participate in any manner in the conduct of the SBLC's affairs. Change of ownership or control shall include:

(1) Any transfer of 10 percent or more of any class of the SBLC's stock, and any agreement providing for such transfer;

(2) Any transfer that could result in the beneficial ownership by any person or group of persons acting in concert of 10 percent or more of any class of its

stock, and any agreement providing for such transfer;

(3) Any merger, consolidation, or reorganization; or

(4) Any other transaction or agreement that transfers control of the SBLC.

(b) If transfer of ownership or control is subject to the approval of any State or Federal chartering, licensing, or other regulatory authority, copies of any documents filed with such authority shall, at the same time, be transmitted to the SBA District Office serving the area in which the SBLC's principal office is located.

#### § 120.474 Prohibited financing.

An SBLC may not make a loan to a small business that has received financing (or a commitment for financing) from an SBIC that is an Associate of the SBLC.

#### § 120.475 Suspension or revocation.

SBA may revoke or suspend an SBLC for a violation of law, these regulations, or any agreement with SBA. An appeal can be made following the procedures set forth in part 134 of this chapter.

### Subpart E—Loan Administration

#### § 120.500 General.

This subpart outlines the general loan administration policies applicable to SBA financial assistance.

#### Servicing

#### § 120.510 Servicing direct and immediate participation loans.

SBA services the direct loans that it makes. Generally, the Lender services immediate participation loans that it makes and in which SBA participates.

#### § 120.511 Servicing guaranteed loans.

The Lender services guaranteed loans, holds the Loan Instruments and receives the Borrower's payments of principal and interest.

#### § 120.512 Who services the loan after SBA honors its guarantee?

Generally, after SBA honors its guarantee, the Lender must continue to hold the Loan Instruments and service the loan, and the Lender must execute a Certificate of interest showing SBA's percentage of the loan. If SBA elects to service the loan, the Lender must assign the Loan Instruments to SBA.

#### § 120.513 What servicing actions require the prior written consent of the SBA?

SBA must give its prior written consent before the Lender takes any of the following actions:

(a) Alter substantially the terms or conditions of any Loan Instrument (for

example, any increase in the principal amount or change in the interest rate, or conferring a Preference on the Lender);

(b) Release collateral having a cumulative value in excess of 20 percent of the original loan amount;

(c) Accelerate the maturity of the note;

(d) Sue upon any Loan Instrument;

(e) Compromise or waive any claim against any Borrower, guarantor, obligor or standby creditor arising out of any Loan Instrument; or

(f) Increase the amount of any prior lien held by the Lender on the collateral securing the loan.

#### SBA'S Purchase of a Guaranteed Portion

#### § 120.520 When does SBA honor its guarantee?

(a) SBA, in its sole discretion, may purchase a guaranteed portion of a loan at any time. A Lender may demand in writing that SBA honor its guarantee if the Borrower is in default on any installment for more than 60 calendar days (or less if SBA agrees) and the default has not been cured. If a Borrower cures a default before a Lender requests purchase by SBA, the Lender's right to request purchase on that default lapses.

(b) When SBA purchases the guaranteed portion, it does not waive any of its rights to recover money paid on the guaranty, based upon the Lender's negligence, misconduct, or violation of this part, including the those actions listed in § 120.524(a), the guarantee agreement or the Loan Instruments.

#### § 120.521 What interest rate applies after SBA purchases its guaranteed portion?

When SBA honors its guarantee for a fixed interest rate loan, the rate of interest remains as stated in the note. On loans with a fluctuating interest rate, the interest rate that the Borrower owes will be at the rate in effect at the time of the earliest uncured default (where a default has occurred), or the rate in effect at the time of purchase (where no default has occurred).

#### § 120.522 How much accrued interest does SBA pay to the Lender or Registered Holder when SBA purchases the guaranteed portion?

(a) *Rate of interest.* If SBA purchases the guaranteed portion from a Lender or from a Registered Holder (if sold in the Secondary market), it will pay accrued interest at:

(1) The rate in the note if it is a fixed rate loan; or

(2) The rate in effect on the date of the earliest uncured default (if a default has occurred) or of SBA's purchase (if there has been no default).

(b) *Payment to Lender.* SBA calculates the accrued interest due a Lender from the date of the Borrower's earliest uncured default, but interest may not accrue for more than 120 days (plus any deferment period which SBA had approved). In addition, if a Lender requests SBA to purchase within 120 days of the earliest uncured default, SBA will pay accrued interest to the Lender for any SBA time spent in making payment in excess of 120 days, plus interest from the last paid-to date to the earliest uncured default date.

(c) *Payment to Registered Holder.* SBA will pay a Registered Holder all accrued interest up to the date of payment.

(d) *Extension of the 120 day period.* Before the 120 days expire, the SBA field office may extend the period if the Lender and SBA agree that the Borrower can cure the default within a reasonable and definite period of time or that the benefits from doing so otherwise will exceed the costs of SBA paying additional interest. If the 120 days have passed, only SBA's AA/FA or his designee can extend the period.

#### § 120.523 What is the "earliest uncured default"?

Default occurs when a Borrower violates any provision in the Loan Instruments. The default date is the date the violation occurred. The "earliest uncured default" is the earliest violation not yet cured. If the violation is the failure by a Borrower to pay a regular installment of principal and interest when due, payments made by the Borrower before a Lender makes its request to SBA to purchase are applied to the earliest uncured default. If the installment is paid in full, the earliest uncured default date will advance to the next unpaid installment date. If a Borrower makes any payment after a Lender makes its request to SBA to purchase, the earliest uncured default date does not change because the Lender has already exercised its right to request purchase.

#### § 120.524 When is SBA released from liability on its guarantee?

(a) SBA is released from liability on a loan guarantee (in whole or in part, within SBA's exclusive discretion), if any of the events below occur:

(1) The Lender has failed to comply with any of the provisions of these regulations, the Loan Guarantee Agreement, or the Authorization;

(2) The Lender has failed to make, close, service, or liquidate a loan in a prudent manner;

(3) The Lender's improper action or inaction has placed SBA at risk;

(4) The Lender has failed to disclose a material fact to SBA regarding a guaranteed loan in a timely manner;

(5) The Lender has misrepresented a material fact to SBA regarding a guaranteed loan;

(6) SBA has received a written request from the Lender to terminate the guarantee;

(7) The Lender has not paid the guarantee fee within the period required under SBA rules and regulations;

(8) The Lender has failed to request that SBA purchase a guarantee within 120 days after maturity of the loan;

(9) The Lender has failed to use required SBA forms or exact electronic copies; or

(10) The Borrower has paid the loan in full.

(b) If SBA determines, after purchasing its guaranteed portion of a loan, that any of the events set forth in paragraph (a) of this section occurred in connection with that loan, SBA is entitled to recover any money paid on the guaranty plus interest from the Lender responsible for those events.

(c) If the Lender's loan documentation indicates that one or more of the events in paragraph (a) of this section may have occurred, SBA may undertake such investigation as it deems necessary to determine whether to honor or deny the guarantee, and may withhold a decision on whether to honor the guarantee until the completion of such investigation.

(d) Any information provided to SBA prior to Lender's request for SBA to honor its guarantee shall not prejudice SBA's right to deny liability for a guarantee if one or more of the events listed in paragraph (a) of this section occur.

(e) Unless SBA provides written notice to the contrary, the Lender remains responsible for all loan servicing and liquidation actions until SBA honors its guarantee in full.

Deferment, Extension of Maturity and Loan Moratorium

#### **§ 120.530 Deferment of payment.**

SBA may agree to defer payments for a stated period of time, and use such other methods as it considers necessary and appropriate to help in the successful establishment and operation of the Borrower. This policy applies to all business loan programs, including 504 loans.

#### **§ 120.531 Extension of maturity.**

SBA may agree to extend the maturity of a loan for up to 10 years beyond its original maturity if the extension will aid in the orderly repayment of the loan.

#### **§ 120.532 What is a loan Moratorium?**

SBA may assume a Borrower's obligation to repay principal and interest on a loan by agreeing to make the payments to the Participating Lender on behalf of the Borrower. This relief is called a "Moratorium."

#### **§ 120.533 When will SBA grant a Moratorium?**

SBA normally will grant a Moratorium if:

(a) Without it, the small business will become or remain insolvent;

(b) With it, the small business will become or remain viable;

(c) Alternative remedies, such as a deferment, are not available;

(d) The Lender has already granted deferments equal to at least six (6) monthly installments, and the Lender and SBA agree that the deferments have been beneficial;

(e) The Borrower, Lender, obligors, and guarantors execute a "Moratorium Agreement" giving SBA absolute discretion to discontinue making the payments at any time;

(f) The Borrower (and co-Borrowers) execute a demand note to repay SBA's Moratorium advances;

(g) All guarantors or other obligors of the guaranteed loan execute guarantee agreements and any other instruments required by SBA to protect its interests under the demand note;

(h) The Borrower and other obligors provide such security as SBA considers necessary or appropriate; and

(i) The collateral securing the demand note includes at least the collateral securing the guaranteed loan, and the collateral position for the demand note is subject only to the lien position on the guaranteed loan.

#### **§ 120.534 How long can a Moratorium continue?**

Generally, SBA will continue a Moratorium for six months, although SBA may authorize an initial Moratorium for up to one year. SBA may continue a Moratorium for additional periods (to a maximum total of five (5) years) only if the Borrower can demonstrate the eventual ability to repay from earnings the original note and the demand note.

#### **§ 120.535 What are the repayment terms of a Moratorium?**

(a) The interest rate for the demand note is the same as for the guaranteed loan. SBA advances to a Participating Lender during the Moratorium period accrue interest from the date of each disbursement.

(b) SBA has the right to demand payment at any time. If not previously

demand, payment in full will be due immediately after the Borrower has fully paid the guaranteed loan.

(c) SBA may demand payment in full under the demand note or SBA may accept a repayment schedule. If the loan has been paid, the frequency and amount of the repayments must be at least equal to the amount and frequency that were due under the loan.

(d) SBA will apply repayments first to accrued interest and then to principal.

(e) A loan may be extended beyond the statutory limit for a period of time corresponding to the time of the Moratorium.

#### **Liquidation of Collateral**

#### **§ 120.540 What are SBA's policies concerning liquidation of collateral?**

(a) *Liquidation policy.* SBA or the Lender may liquidate collateral securing a loan if there is no reasonable prospect that the Borrower or a guarantor (other than SBA) can repay the loan within a reasonable period.

(b) *Sale and conversion of loans.* Without the consent of the Borrower, SBA may:

(1) Sell a direct loan;

(2) Convert a guaranteed or immediate participation loan to a direct loan; or

(3) Convert an immediate participation loan to a guaranteed loan or a loan owned solely by the Lender.

(c) *Dispose of collateral and assets acquired through foreclosure or conveyance.* SBA or the Lender may sell real and personal property (including contracts and claims) pledged to secure a loan that is in default in accordance with the provisions of the related security instrument (see § 120.550 for Homestead Protection for Farmers).

(1) *Competitive bids or negotiated sale.* Generally, SBA or the Lender will offer loan collateral and acquired assets for public sale through competitive bids at an auction or a sealed bid sale, although a negotiated sale may be utilized under appropriate circumstances.

(2) *Lease of acquired property.* Normally, neither SBA nor a Lender will rent or lease acquired property or grant options to purchase. SBA will consider proposals for a lease if it appears a property cannot be sold advantageously and it is in the government's interest, but SBA may terminate the lease upon receipt of a favorable purchase offer.

(d) *Recoveries and security interests shared.* SBA and the Participating Lender will share pro rata (in accordance with their respective interests in a loan) all loan payments or recoveries, all reasonable expenses

(including advances for the care, preservation, and maintenance of collateral securing the loan), and any security interest or guarantee (excluding SBA's guarantee) which the Lender or SBA may hold or receive in connection with a loan.

(e) *Guarantors.* Guarantors of financial assistance have no rights of contribution against SBA on an SBA guaranteed or direct loan. SBA is not deemed to be a co-guarantor with any other guarantors.

#### Homestead Protection for Farmers

##### § 120.550 What is homestead protection for farmers?

SBA may lease to a farmer-Borrower the farm residence occupied by the Borrower and a reasonable amount of adjoining property (no more than 10 acres and seven farm buildings), if they were acquired by SBA as a result of a defaulted farm loan made or guaranteed by SBA (see the Consolidated Farm and Rural Development Act, 7 U.S.C. 1921, for qualifying loan purposes).

##### § 120.551 Who is eligible for homestead protection?

SBA must notify the Borrower in possession of the availability of these homestead protection rights within 30 days after SBA acquires the property. A farmer-Borrower must:

- (a) Apply for the homestead occupancy to the SBA field office which serviced the loan within 90 days after SBA acquires the property;
- (b) Provide evidence that the farm produces farm income reasonable for the area and economic conditions;
- (c) Show that at least 60 percent of Borrower's gross annual income came from farm or ranch operations in at least any two out of the last six calendar years;
- (d) Have resided on the property during the previous six years; and
- (e) Be personally liable for the debt.

##### § 120.552 Lease.

If approved, the applicant must personally occupy the residence during the term of the lease and pay a reasonable rent to SBA. The lease shall be for a period not to exceed 5 years, renewable for up to another 5 years. During or at the end of the lease period, the lessee has a right of first refusal to reacquire the homestead property under terms and conditions no less favorable than those offered to any other purchaser.

##### § 120.553 Appeal.

If the application is denied, the Borrower may appeal the decision to the Regional Administrator in the region in

which the field office which denied the application is located. Until the conclusion of any appeal, the Borrower may retain possession of the homestead property. If there is a conflict between state law and this section, state law prevails.

#### Subpart F—Secondary Market

##### § 120.600 What is the SBA Secondary Market?

The SBA secondary market ("Secondary Market") consists of the sale of Certificates, representing either the entire guaranteed portion of an individual 7(a) guaranteed loan or an undivided interest in a Pool consisting of the SBA guaranteed portions of a number of 7(a) guaranteed loans. By the terms of the Certificate, SBA guarantees a Registered Holder timely payment of principal and interest to which the Registered Holder is entitled from the loan or loans underlying the Certificate. Transactions involving interests in Pools or the sale of individual guaranteed portions are governed by the contracts entered into by the parties, SBA's Secondary Market Program Guide, and this subpart. See sections 5 (f), (g) and (h) of the Small Business Act (15 U.S.C. 634 (f), (g) and (h)).

##### § 120.601 Definitions.

The definitions in this section apply throughout this subpart.

(a) *Certificate* is the document the FTA issues representing a beneficial fractional interest in a Pool (Pool Certificate), or an undivided interest in the entire guaranteed portion of an individual 7(a) guaranteed loan that is sold separately.

(b) *Current* means that no repayment from a Borrower to a Lender is over 29 days late measured from the due date of the payment on the records of the FTA's central registry (Pools) or the entity servicing the loan (individual guaranteed portion).

(c) *FTA* is the SBA's fiscal and transfer agent.

(d) *Note Rate* is the interest rate on the Borrower's note.

(e) *Net Rate* means the interest rate on an individual guaranteed portion in a Pool.

(f) *Payment date* is the date that the FTA deposits checks in the U.S. mail. SBA may change the date or method of payment by publishing a document in the Federal Register.

(g) *Pool* is an aggregation of SBA guaranteed portions of loans made by Lenders.

(h) *Pool Assembler* is a financial institution that:

(1) Organizes and packages a Pool by acquiring the SBA guaranteed portions of loans from Lenders;

(2) Resells fractional interests in the Pool to Registered Holders; and

(3) Directs the FTA to issue Certificates.

(i) *Pool Rate* means the interest rate on a Certificate.

(j) *Registered Holder* is the Certificate owner listed in FTA's records.

#### Certificates

##### § 120.610 Description of Certificates.

(a) *General form and content.* Each Certificate must be registered with the FTA (no bearer Certificates). SBA must approve the terms of the Certificate.

(b) *Face amount of Pool Certificate.* The face amount of a Pool Certificate cannot be less than a specified minimum amount and must be in increments which SBA may specify (except for one Certificate in each Pool). SBA may change these requirements by issuing a document in the Federal Register after analyzing market conditions and program experience.

(c) *Payment Terms for Pool Certificates.* Principal installments and interest payments are based on the unpaid principal balance of the portion of the Pool represented by a Pool Certificate. All prepayments on loans in the Pool must be passed through to the Registered Holders on the payment date.

(d) *Payment Terms for Certificates which represent individual guaranteed portions.* Principal installments and interest payments are based on the unpaid principal balance of the entire SBA guaranteed portion of the loan. The Certificate must provide for a pro rata pass through to the Registered Holder of payments which the FTA receives from a Lender or any entity servicing the loan.

##### § 120.611 Description of Pools backing Pool Certificates.

(a) *Pool characteristics.* (1) When the FTA issues a Pool Certificate, each Pool must have:

(i) A minimum number of guaranteed portions of loans;

(ii) A minimum aggregate principal balance of the guaranteed portions;

(iii) A maximum percentage of the Pool which an individual guaranteed portion may constitute;

(iv) A maximum allowable difference between the highest and lowest note interest rates;

(v) A maximum allowable difference between the remaining terms to maturity of the loans in the Pool; and

(vi) A minimum weighted average maturity at Pool formation.

(2) SBA may adjust the Pool characteristics periodically based upon

program experience and market conditions.

(b) *Interest rate on Pool Certificate.* The interest rate on a pool Certificate must be equal to the lowest net rate on any individual guaranteed portion in the pool.

(c) *Redemption of Certificate.* The FTA and SBA may redeem a pool Certificate because of prepayment or default of all loans constituting the pool.

**§ 120.612 What loans are eligible to back Certificates?**

(a) Pool Certificates are backed by the SBA guaranteed portions of loans comprising the Pool. An individual Certificate is backed by the entire SBA guaranteed portion of a single loan. Each such loan must:

(1) Be current as of the date the Pool is formed or the individual loan is initially sold in the Secondary Market;

(2) Be guaranteed under the Act; and

(3) Meet such other standards as SBA may determine to be necessary for the successful operation of the pooling program.

(b) With respect to any Pool, the loans must meet the SBA standards in effect at the time the Pool is formed.

**§ 120.613 What is a Secondary Participation Guarantee Agreement?**

When a Lender wants to sell the guaranteed portion of a loan, it enters into a Secondary Participation Guarantee Agreement ("SPGA") with SBA and the purchaser of the guaranteed portion. The terms of sale between the Lender and the purchaser cannot require the Lender or SBA to repurchase except in accordance with the terms of the SPGA. Before execution of the agreement, the Lender must:

(a) *Documents.* Submit to SBA a copy of the SPGA, the note, and such other documents as SBA may require;

(b) *Full Disbursement.* Disburse to the Borrower the full amount of the loan; and

(c) *Guarantee Fees Paid.* Pay SBA all guarantee fees in full.

The SBA Guarantee of a Certificate

**§ 120.620 The SBA guarantee of a Pool Certificate.**

(a) *Extent of Guarantee.* SBA guarantees to a Registered Holder the timely payment of principal and interest installments and any prepayment or other recovery of principal on the underlying loans to which the Registered Holder is entitled. If the Borrower of a loan in a Pool backing the Certificates does not make a required installment payment, SBA through the FTA must make advances to maintain the schedule of interest and principal

payments to the Registered Holders until SBA purchases the guaranteed portion.

(b) *SBA guarantee backed by full faith and credit.* SBA's guarantee of the Pool Certificate is backed by the full faith and credit of the United States.

**§ 120.621 The SBA guarantee of a Certificate representing an individual guaranteed portion.**

(a) *Extent of SBA guarantee.* With respect to individual SBA guaranteed portions sold in the Secondary Market, SBA guarantees to purchase from the Registered Holder the guaranteed portion for an amount equal to the unpaid principal and accrued interest due on the guaranteed portion of the note as of the date of SBA's purchase, less deductions for applicable fees. As opposed to the SBA guarantee with respect to pooled loans, SBA does not guarantee timely payment on individual guaranteed portions.

(b) *What triggers the SBA guarantee.* SBA's guarantee to the Registered Holder may be called upon when:

(1) The Borrower remains in uncured default for 60 days on payments of principal or interest due on the note;

(2) The Lender fails to send to the FTA payments it received from the Borrower; or

(3) The FTA fails to send to the Registered Holder any payments it has received from the Lender.

(c) *Full faith and credit.* SBA's guarantee to the Registered Holder is unconditional and is backed by the full faith and credit of the United States.

Pool Assemblers

**§ 120.630 Qualifications to be a Pool Assembler.**

(a) *Application to become Pool Assembler.* The application to become a Pool Assembler is available from the AA/FA. In order to qualify as a Pool Assembler, an entity must send the application to the AA/FA, with an application fee, and certify that it:

(1) Is regulated by the appropriate agency as defined in section 3(a)(34)(G) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(34)(G));

(2) Meets all financial and other applicable requirements of its regulatory authority and the Government Securities Act of 1986, as amended (Pub. L. 99-571, 100 Stat. 3208);

(3) Has the financial capability to assemble acceptable and eligible guaranteed loan portions in sufficient quantity to support the issuance of Pool Certificates; and

(4) Is in good standing with SBA (as the AA/FA determines), the Office of the Comptroller of the Currency

("OCC") if it is a national bank, the Federal Deposit Insurance Corporation if it is not a national bank, or the National Association of Securities Dealers.

(b) *Approval by SBA.* After SBA approves the application to become a Pool Assembler, the entity may submit Pool applications to the FTA.

(c) *Conduct of business by Pool Assembler.* An entity continues to qualify as a Pool Assembler so long as it:

(1) Meets the eligibility standards in paragraph (a) of this section;

(2) Conducts its business in accordance with SBA regulations and accepted securities or banking industry practices, ethics, and standards; and

(3) Maintains its books and records in accordance with generally accepted accounting principles or in accordance with the guidelines of the regulatory body governing its activities.

**§ 120.631 Suspension or termination of eligibility of Pool Assembler.**

(a) *Suspension or termination.* The AA/FA may suspend a Pool Assembler from operating in the Secondary Market for up to 18 months or terminate its eligibility, if the Pool Assembler (and/or its Associates):

(1) Does not comply with any of the requirements in § 120.630(a) and (c);

(2) Has been indicted or otherwise formally charged with, or convicted of, a misdemeanor or felony;

(3) Has received an adverse final civil judgment that it has committed a breach of trust or a violation of a law or regulation protecting the integrity of business transactions or relationships;

(4) Has not formed a Pool for at least 3 years; or

(5) Is under investigation by its regulating authority for activities which may affect its ability to participate in the Secondary Market.

(b) *Suspension procedures.* The AA/FA shall notify a Pool Assembler by certified mail, return receipt requested, of the decision to suspend and the reasons therefore at least 10 business days prior to the effective date of the suspension. The Pool Assembler may appeal the suspension made under this section pursuant to the procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

(c) *Notice of termination.* In order to terminate a Pool Assembler's eligibility, the AA/FA must issue an order to show cause why the SBA should not terminate the Pool Assembler's participation in the Secondary Market. The Pool Assembler may appeal the termination made under this section

pursuant to procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

### Sale of Certificates

#### § 120.640 Administration of the Pool and individual guaranteed portions.

(a) *FTA responsibility.* The FTA has the responsibility to administer each Pool or individual guaranteed portion. It shall maintain a registry of Registered Holders and other information as SBA requires.

(b) *Self-liquidating.* Each Pool or individual guaranteed portion in the Secondary Market is self-liquidating because of Borrower payments or prepayments, redemption by SBA, and/or payments by SBA or the Lender after default by the Borrower. There is no substitution of the guaranteed portions of existing loans for defaulted loans.

(c) *SBA's right to subrogation.* If SBA pays a claim under a guarantee with respect to a Certificate issued under this subpart, it must be subrogated fully to the rights satisfied by such payment.

(d) *SBA ownership rights not limited.* No Federal, State or local law can preclude or limit the exercise by SBA of its ownership rights in the portions of loans constituting the Pool against which the Certificates are issued.

#### § 120.641 Disclosure to purchasers.

(a) *Information to purchaser.* Prior to any sale, the Pool Assembler, Registered Holder of a Certificate representing an individual guaranteed portion, or any subsequent seller must disclose to the purchaser, either orally or in writing, information on the terms, conditions, and yield as described in the SBA Secondary Market Program Guide.

(b) *Information on transfer document.* The seller must provide the same information described in paragraph (a) of this section in writing on the transfer document when the seller submits it to the FTA. After the sale of an individual Certificate, the FTA will provide the disclosure information in writing to the purchaser.

(c) *Information in prospectus.* If the Registered Holder is a trust, investment Pool, mutual fund or other security, it must disclose the information in (a) above to investors through a prospectus and other promotional material if a Certificate or Pool Certificate is placed into or used as the backing for the investment vehicle.

#### § 120.642 Requirements before the FTA issues Pool Certificates.

Before the FTA issues any Pool Certificate, the Pool Assembler must deliver to it the following documents:

(a) A properly completed Pool application form;

(b) Either:

(1) Certificates evidencing the guaranteed portions comprising the Pool; or

(2) An executed SPGA and related documentation for the loans whose guaranteed portions are to be part of the Pool; and

(c) Any other documentation which SBA may require.

#### § 120.643 Requirements before the FTA issues the Certificate for an individual guaranteed portion.

(a) *FTA issuance of initial Certificate.* Before the FTA can issue the initial Certificate for a particular guaranteed portion, the original seller must provide the following documents to the FTA:

(1) An executed SPGA;

(2) A copy of the note representing the guaranteed loan; and

(3) Any other documentation which SBA may require.

(b) *Review of documentation.* SBA may review or require the FTA to review any documentation before the FTA issues a Certificate.

#### § 120.644 Sale of individual SBA guaranteed portion.

(a) *Amount of Certificate.* Each Certificate which represents the guaranteed portion of a single loan must be for the entire amount of the guaranteed portion.

(b) *General rule on transferability of Certificate.* Each such Certificate is transferable only on the books and records of the FTA or SBA.

(c) *Lender cannot purchase guaranteed portion of loan it made.* The Lender (or its Associate) that made the loan cannot purchase the guaranteed portion in the Secondary Market. If a Lender does purchase the guaranteed portion of one of its own loans, it shall not have the unconditional guarantee of SBA.

(d) *Prepayment or default.* The prepayment of the underlying loan or a default on such loan will trigger the redemption of the Certificate by FTA/SBA in accordance with the procedures prescribed in the SPGA.

#### § 120.645 Transfers of Certificates.

(a) *General rule.* Certificates are transferable. Transfers in the Secondary Market must comply with Article 8 of the Uniform Commercial Code of the State of New York. The seller must use the detached form of assignment (SBA Form 1088), unless the seller and purchaser choose to use another form which the SBA approves. The FTA may refuse to issue a Certificate until it is

satisfied that the documents of transfer are complete.

(b) *Transfer on FTA records.* In order for the transfer of a Certificate to be effective the FTA or SBA must reflect it on their records.

(c) *Contents of letter of transmittal accompanying the transfer of Certificates.* (1) A letter of transmittal must accompany each Certificate which a Registered Holder submits to the FTA for transfer. The Registered Holder must supply the following information:

(i) Pool number, if applicable;

(ii) Certificate number;

(iii) Name of purchaser of Certificate;

(iv) Address and tax identification number of the purchaser;

(v) Name and telephone number of the person handling or facilitating the transfer;

(vi) Instructions for the delivery of the new Certificate.

(2) With this information, the seller of the Certificate must send the fee which the FTA charges for this service. The FTA will supply fee information to the seller.

### Fiscal and Transfer Agent (FTA)

#### § 120.650 Registration duties of FTA in Secondary Market.

The FTA registers all Certificates. This means it issues, transfers title to, and redeems them. All financial transactions relating to a guaranteed portion of a loan flow through the FTA. The FTA must keep the central registry current, using the following information required for each registration:

(a) The Lender that made and sold the loan;

(b) The interest rate paid by the Borrower to the Lender (including whether the rate is fixed or variable);

(c) The Lender's servicing fee;

(d) The purchaser;

(e) The price paid by the purchaser;

(f) The interest rate paid on the Certificate or Pool Certificate;

(g) The fees which the FTA charges to register and issue Certificates; and

(h) Any other information which SBA requires.

#### § 120.651 Claim to FTA by Registered Holder to replace Certificate.

(a) To replace a Certificate because of loss, theft, destruction, mutilation, or defacement, the Registered Holder must:

(1) Give the FTA information about the Certificate and the facts relating to the claim;

(2) File an indemnity bond acceptable to SBA and the FTA with a surety to protect the interests of SBA and the FTA;

(3) Pay the FTA its fee to replace a Certificate; and

(4) Use an affidavit of loss (form available from the FTA) to report:

- (i) The name and address of the Registered Holder (and the name and capacity of any representative actually filing the claim);
- (ii) The Certificate by Pool number, if applicable;
- (iii) The Certificate number;
- (iv) The original principal amount;
- (v) The name in which the Certificate was registered;
- (vi) Any assignment, endorsement or other writing on the Certificate; and
- (vii) A statement of the circumstances of the theft or loss.

(b) When the FTA receives notice of the theft or loss, it will stop any transfer of the Certificate. The Registered Holder must send to the FTA all available portions of a mutilated or defaced Certificate. When the Registered Holder completes these steps, the FTA will replace the Certificate.

#### § 120.652 FTA fees.

The FTA may charge reasonable servicing fees, transfer fees, and other fees as the SBA and FTA may negotiate under contract.

#### Suspension or Revocation of Participant in Secondary Market

##### § 120.660 Suspension or revocation.

(a) *Suspension or revocation of Lender, broker, dealer, or Registered Holder for violation of Secondary Market rules and regulations.* The AA/FA may suspend or revoke the privilege of a Lender, broker, dealer, or Registered Holder to sell, purchase, broker, or deal in loans or Certificates for:

- (1) Committing a serious violation, in SBA's discretion, of:
  - (i) The rules and regulations of the Secondary Market; or
  - (ii) Any provisions in the contracts entered into by the parties, including SBA Forms 1085, 1086, 1088 and 1454; or
- (2) Knowingly submitting false or fraudulent information to the SBA or FTA.

(b) *Additional rules for suspension or revocation of broker or dealer.* In addition to acting under paragraph (a) of this section, the AA/FA may suspend or revoke any broker or dealer from selling or otherwise dealing in Certificates in the Secondary Market if:

- (1) Its supervisory agency has revoked or suspended the broker or dealer from engaging in the securities business, or is investigating the firm or broker for a practice which SBA considers, in its sole discretion, to be relevant to the broker's or dealer's fitness to participate in the Secondary Market;

(2) The broker or dealer has been indicted or otherwise formally charged with a misdemeanor or felony which bears on its fitness to participate in the Secondary Market; or

(3) A final civil judgment is entered holding that the broker or dealer has committed a breach of trust or a violation of any law or regulation protecting the integrity of business transactions or relationships.

(c) *Notice to suspend or revoke.* The AA/FA shall notify the affected party in writing, providing the reasons therefore, at least 10 business days prior to the effective date of the suspension or revocation. The affected party may appeal the suspension or revocation made under this section pursuant to the procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal. Revocation shall last a minimum of 5 years.

#### Subpart G—Microloan Demonstration Program

##### § 120.700 What is the Microloan Program?

(a) The Microloan Demonstration Program assists women, low income individuals, minority entrepreneurs, and other small businesses ("Microloan Borrowers") who need smaller amounts of financial assistance, but still have limited access to credit. The program has been authorized through September 30, 1997.

(b) Under this program, SBA makes direct and guaranteed loans to Intermediaries (as defined below) who use the proceeds to make loans to Microloan Borrowers. SBA also may make grants to these Intermediaries to be used for marketing, management, and technical assistance to the Microloan Borrowers.

(c) SBA also may make grants to qualified non-profit entities, who are not Intermediaries, to provide marketing, management and technical assistance to Microloan Borrowers seeking to start or enlarge small businesses.

(d) An Intermediary cannot operate in more than one state unless the AA/FA determines that it would be in the best interests of the small business community to operate across state lines.

##### § 120.701 Definitions.

(a) *Deposit account* is a demand, time, savings, passbook, or similar account maintained with an insured depository institution (not including an account evidenced by a Certificate of Deposit).

(b) *Economically Distressed Area* is a county or equivalent division of local government of a state in which,

according to the most recent available data from the United States Bureau of the Census, 40 percent or more of the residents have an annual income that is at or below the poverty level.

(c) *Grant* is a Federal award of money, or property in lieu of money (including cooperative agreements) to an eligible grantee that must account for its use. The term does not include the provision of technical assistance, revenue sharing, loans, loan guarantees, interest subsidies, insurance, direct appropriations, or any fellowship or other lump sum award.

(d) *Insured depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act, 12 U.S.C. 1813(c).

(e) *Intermediary* is an entity participating in the Microloan Demonstration Program which has made and serviced microloans to small businesses for at least one year, and which provides marketing, management, and technical assistance to its Microloan Borrowers. It may be:

- (1) A private, nonprofit community development corporation or other entity;
- (2) A consortium of private, nonprofit community development corporations or other entities;
- (3) A quasi-governmental economic development entity, other than a State, county, municipal government or any agency thereof; or
- (4) An agency of or a non-profit entity established by a Native American Tribal Government.

(f) *Microloan* is a short-term, fixed interest rate loan of not more than \$25,000 made by an Intermediary to an eligible small business.

(g) *Non-Federal sources* are funds acquired from sources other than the Federal Government and may include indirect costs or in-kind contributions paid for under non-Federal programs.

(h) *Specialized Intermediary* means an Intermediary which maintains a portfolio of microloans averaging \$7,500 or less.

##### § 120.702 Are there limits on Intermediaries or loans?

(a) SBA will not allow a quasi-governmental Intermediary to participate in the program unless:

- (1) No otherwise eligible organization applies; or
- (2) SBA determines that participation by a quasi-governmental Intermediary is in the public interest.

(b) In selecting Intermediaries, SBA will give priority to Specialized Intermediaries.

(c) SBA will not loan more than \$2.5 million collectively per year to the

Intermediaries operating in any one State.

**§ 120.703 How do I apply to become an Intermediary?**

(a) *Application Process.* SBA periodically will solicit applications from prospective Intermediaries in a Program Announcement or Request For Proposal informing you:

- (1) Where to obtain an application package;
- (2) The deadline for submitting your application;
- (3) Where to deliver your completed application.

(b) *Documentation in support of your application.* Your application must include a detailed narrative statement describing:

- (1) The types of businesses which you have assisted in the past and those you intend to assist with Microloans;
- (2) The average size of the loans which you have made in the past and the average size of your intended Microloans;
- (3) The extent to which you will make loans to small businesses in rural areas;
- (4) The geographic area in which you intend to operate, including a description of the economic and demographic conditions existing in your intended area of operations;
- (5) The availability and cost of obtaining credit for small businesses in your area;
- (6) Your experience and qualifications in providing marketing, management, and technical assistance to small businesses;
- (7) Any plan you may have to use other technical assistance (such as counselors from the Service Corps of Retired Executives) to help your microloan borrowers.

(c) *Evaluation.* In evaluating applications to become Intermediaries, SBA shall select applicants that ensure the appropriate availability of Microloans for small businesses in all industry and business sectors located in both rural and urban areas.

**§ 120.704 What is my financial contribution?**

You must contribute from non-Federal sources an amount equal to 15% of any loan that you receive from SBA. The contribution may not be borrowed.

**§ 120.705 Microloan Revolving Fund.**

You must establish a Microloan Revolving Fund ("MRF") in an interest-bearing Deposit Account into which you must deposit your contributions from non-Federal sources, the proceeds from SBA loans, and payments from your Microloan Borrowers. You may only

withdraw from this account the money needed to establish the Loan Loss Reserve Fund (§ 120.706), proceeds for each Microloan you make, and any payments which you owe to SBA.

**§ 120.706 Loan Loss Reserve Fund.**

(a) *General.* You must establish a Loan Loss Reserve Fund ("LLRF") in an interest-bearing Deposit Account. The purpose of the LLRF is to account for any shortage in the MRF caused by delinquencies or losses on your microloans. You must maintain the LLRF until you have repaid all obligations which you owe to SBA.

(b) *Level of Loan Loss Reserve Fund in first year.* In your first year as an Intermediary, the balance on deposit in the LLRF must equal not less than 15% of the total outstanding balance of all notes receivable owed by your Microloan Borrowers.

(c) *Level of Loan Loss Reserve Fund in subsequent years.* In subsequent years as an Intermediary, you must maintain a balance on deposit in the LLRF at a level which reflects your loss experience as determined by SBA. The maximum amount is 15% of the total outstanding balance owed by your Microloan Borrowers.

**§ 120.707 What are the terms and conditions of my Intermediary SBA loan?**

(a) *Loan Amount.* You, together with your affiliates, cannot borrow more than \$750,000 in the first year of your participation in this program. In subsequent years, your obligations owed to SBA cannot exceed an aggregate of \$2,500,000.

(b) *Repayment terms.* During the first year of your loan, you do not have to make any payments, but interest accrues from the date that SBA disburses the loan proceeds to you. After that, SBA will determine your periodic payments. The loan must be repaid within 10 years.

(c) *Interest rate.* If you are a Specialized Intermediary, your interest rate is equal to the rate applicable to 5-year obligations of the United States Treasury, adjusted to the nearest one-eighth percent, less 2 percent; otherwise, your interest rate is equal to the rate applicable to 5-year obligations of the United States Treasury, adjusted to the nearest one-eighth percent, less 1.25 percent.

(1) In determining the applicable interest rate, SBA will measure the average size of the microloans for each of your sites or offices. For purposes of this section, the terms "office" or "site" shall mean a fixed, existing, geographic location established at a specific address.

(2) At the end of your first year of participation in this program, SBA determines whether your actual lending practices qualify you as a Specialized Intermediary. SBA then applies the applicable interest rate retroactively (making adjustments to interest accrued on your loan).

(3) On the anniversary date of the first year interest rate calculation (second and all later years), SBA will determine whether your cumulative actual lending practices qualify you as a Specialized Intermediary. SBA will apply the applicable rate for that year.

(d) *Collateral.* As security for repayment of your SBA loan, you must pledge to SBA a first lien position in your MRF, LLRF, and all notes receivable from your Microloans.

(e) *Default.* If for any reason you are unable to pay SBA when due, SBA may accelerate maturity of your loan and demand payment in full. In this event, or if you violate this part or the terms of your loan agreement, you must surrender possession of all collateral described in paragraph (d) of this section to SBA. You are not obligated to pay SBA any loss or deficiency which may remain after liquidation of the collateral unless the loss was caused by your fraud, negligence, violation of any of the ethical requirements of § 120.140, or violation of any other provision of this part.

(f) *Fees.* SBA does not charge you any fees for a loan under this program. You may, however, pay minimal closing costs to third parties, such as filing and recording fees.

**§ 120.708 What conditions apply to my loans to Microloan Borrowers?**

(a) *General.* You may make Microloans to any small business eligible to receive financial assistance under this Part. You may allow your Borrower to use loan proceeds only for working capital and acquisition of materials, supplies, furniture, fixtures, and equipment. You must exercise prudent lending practices because SBA will not review your Microloans for creditworthiness.

(b) *Amount and maturity.* Generally, you should not loan more than \$10,000 to any Borrower. You may loan more than \$10,000 only if you are satisfied that your Borrower is unable to obtain financing on comparable terms elsewhere and has good prospects for success. You must not loan more than \$25,000 to any Borrower, including affiliates. Each of your Microloans must be repaid within 6 years.

(c) *Interest rate.* (1) The maximum interest rate that you can charge your Microloan Borrowers is:

(i) On loans of more than \$7,500, the interest rate charged on your SBA loan, plus 7.75 percentage points;

(ii) On loans of \$7,500 or less, the interest rate charged on your SBA loan, plus 8.5 percentage points.

(2) Until the determination of your interest rate by SBA at the end of the first year, you should quote Microloan Borrowers two possible interest rates. You may collect interest at the higher rate. After your interest rate is established at the end of your first year, the actual interest rate for your borrowers' loans will be set and their interest payments during the first year adjusted.

**§ 120.709 What records and reports does SBA require?**

You must operate in accordance with applicable statutes, regulations, policy notices, SBA's Standard Operating Procedures (SOPs), and the information in your application. You must supply to SBA current and accurate information about all operational requirements, and maintain records as required by SBA.

**§ 120.710 How does an Intermediary get a grant to assist Microloan Borrowers?**

(a) *General.* If you receive a loan from SBA, you are eligible to receive a grant from SBA equal to 25 percent of the outstanding balance of all loans made to you by SBA. You must contribute, solely from non-Federal sources, an amount equal to 25 percent of the grant, unless you make at least 50 percent of your loans to small businesses located in or owned by residents of an Economically Distressed Area. If you make at least 25 percent of your loans to small businesses located in or owned by residents of an Economically Distressed Area, you will be eligible to receive an additional grant from SBA equal to 5 percent of the outstanding balance of all loans which you have received from SBA (with no obligation to contribute additional matching funds). You may not borrow your contribution. You may only use grant funds to provide your Microloan Borrowers with marketing, management, and technical assistance, except that you may use up to 15 percent of the grant funds to provide information and technical assistance to prospective Microloan Borrowers. You may not contract to have any other person or entity provide these services.

(b) *Specialized Intermediary.* If you are a Specialized Intermediary, you are eligible for an additional grant equal to 5 percent of the total outstanding balance of all loans which you have received from SBA. You are not required to contribute additional

matching funds. You must use the grant proceeds only for marketing, management and technical assistance.

(c) *Determining eligibility.* SBA will determine your eligibility for a grant under this section separately for each loan-making office or site. SBA will measure the average size of your Microloans for each site to see if you qualify for the extra 5 percent.

**§ 120.711 Does SBA provide technical assistance to Intermediaries?**

SBA may procure technical assistance for an Intermediary to improve its knowledge, skill, and understanding of microlending by awarding a grant to a more experienced Intermediary. SBA may also obtain such assistance for prospective Intermediaries in areas of the country that are either underserved or not served by an existing Intermediary.

**§ 120.712 How does a non-Intermediary get a grant?**

(a) *Grant procedure for non-Intermediaries.* Any nonprofit entity that is not an Intermediary may apply to SBA for a grant. To qualify, it must submit information regarding its ability to provide marketing, management, and technical assistance to Microloan Borrowers. If approved, the grant agreement will establish the terms and conditions of the grant.

(b) *Number and amounts of grants.* In each year of the Microloan program, SBA may make no more than 25 grants to non-Intermediaries for terms of up to 5 years. A grant may not exceed \$125,000.

(c) *Contribution by nonprofit entity.* The nonprofit entity must contribute an amount equal to 20 percent of the grant. The contribution from the nonprofit entity shall come solely from non-Federal sources, and may include direct costs or in-kind contributions paid for under non-Federal programs.

**§ 120.713 Does SBA guarantee any loans an Intermediary obtains from another source?**

(a) SBA may guarantee not less than 90 percent of no more than 10 loans by for-profit or non-profit entities (or an alliance of such entities) to intermediaries in urban areas and no more than 10 loans by such entities to intermediaries in Rural Areas.

(b) Any loan under this section shall have a term of 10 years. If you receive such a loan, you will not need to repay any principal or interest during the first year, although the interest will accrue. During the second through fifth years, you will pay interest only. During the sixth through tenth years you will pay interest and fully amortize the principal.

(c) The interest rate on any loan under this section shall be calculated as described in § 120.707.

**Subpart H—Development Company Loan Program (504)**

**§ 120.800 What is the purpose of the 504 program?**

As authorized by Congress, SBA has established this program to foster economic development, create or preserve job opportunities, and stimulate growth, expansion, and modernization of small businesses.

**§ 120.801 How is a 504 Project financed?**

A small business may apply for 504 financing through the CDC servicing the area in which the business is located. SBA issues an Authorization if it agrees to guarantee part of the funding for a Project. Usually, a Project requires interim (construction) financing from an interim lender (often the same lender that later provides a portion of the permanent financing). Generally, permanent financing of the Project consists of a private sector loan in the amount of 50 percent of the Project costs which is collateralized by a first lien on the Project Property, a loan made with the proceeds of a CDC Debenture in the amount of 40 percent of the Project costs, collateralized by a second lien on the Project Property, and a contribution by the small business in the amount of 10 percent of the Project costs. The Debenture is guaranteed 100 percent by SBA (with the full faith and credit of the United States), and sold to Underwriters who form Debenture Pools. Investors purchase interests in Debenture Pools and receive Certificates representing ownership of all or part of a Debenture Pool. SBA and CDCs use various agents to facilitate the sale and service of the Certificates and the orderly flow of funds among the parties.

**§ 120.802 Definitions.**

The following terms have the same meaning wherever they are used in this subpart. Defined terms are capitalized wherever they appear.

*Area of Operations* is a geographic area in which a CDC conducts its activities.

*Associate Development Company (ADC)* is an entity approved by SBA to assist CDCs to deliver 504 financing.

*Central Servicing Agent (CSA)* is an entity that receives and disburses funds among the various parties involved in 504 financing under a master servicing agent agreement with SBA.

*Certificate* is a document issued by SBA or its agent representing ownership of all or part of a Debenture Pool.

*Debenture* is an obligation issued by a CDC and guaranteed 100 percent by SBA, the proceeds of which are used to fund a 504 loan.

*Debenture Pool* is an aggregation of Debentures formed by an Underwriter.

*Job Opportunity* is a full time (or equivalent) permanent job created within two years of receipt of 504 funds, or retained in the community because of a 504 loan.

*Net Debenture Proceeds* are the portion of Debenture proceeds that finance eligible Project costs (excluding administrative costs).

*Project* is the purchase or lease, and/or improvement or renovation of long-term fixed assets by a small business, with 504 financing, for use in its business operations.

*Project Property* is one or more long-term fixed assets, such as land, buildings, machinery, and equipment, acquired or improved by a small business, with 504 financing, for use in its business operations.

*Substantial Increase in Unemployment is:*

(1) A reduction of one-third or more in the workforce of a relocating small business; or

(2) An increase in unemployment in a redevelopment area (as designated by the Department of Commerce), a Labor Surplus Area (designated by the Department of Labor), or in an area which has an unemployment rate at least 20 percent higher than the national average.

*Third Party Loan* is a loan from a commercial or private lender, investor, or Federal (non-SBA), State or local government source obtained by the Borrower as part of the Project financing.

*Underwriter* is an entity approved by SBA to form Debenture Pools and arrange for the sale of Certificates.

Certification Procedures To Become a CDC

#### **§ 120.810 Applications for certification as a CDC.**

(a) Applicants for certification as a CDC must apply to the SBA District Office serving a proposed Area of Operations. An applicant must demonstrate that it satisfies the certification and operating criteria in §§ 120.820–120.829, as well as:

(1) The need for 504 services (if there is already a CDC in the Area of Operations, the applicant must justify the need for another and present a plan to avoid duplication or overlap);

(2) A budget, approved by its Board of Directors; and

(3) A plan to meet CDC operating requirements (without specializing in a particular industry).

(b) The AA/FA, with the recommendation of each District Office in the applicant's proposed Area of Operations, shall make the certification decision.

#### **§ 120.811 Public notice of CDC certification application.**

(a) As part of the application process, the applicant must publish a notice in a general circulation newspaper in the proposed Area of Operations, including the name and location of the proposed CDC, its purpose and Area of Operations, and the names of its officers and directors. The applicant shall send a copy of the notice to SBA. The notice shall provide the public at least 30 days to submit written comments to the District Office. The SBA shall consider the comments in making its decision on the application.

(b) CDCs serving the proposed Area of Operations shall be directly notified and given at least 30 days to comment.

#### **§ 120.812 Probationary period for newly certified CDCs.**

(a) Newly certified CDCs will be on probation for a period of two years, at the end of which the CDC must petition for:

- (1) Permanent CDC status;
- (2) A single, one-year extension of probation; or
- (3) ADC status.

(b) SBA shall consider failure to file a petition before the end of the probationary period as a withdrawal from the 504 program. If the CDC elects ADC status or withdrawal, it must transfer all funded and/or approved loans to another CDC, SBA, or another servicer approved by SBA.

Requirements for CDC Certification and Operation

#### **§ 120.820 CDC non-profit status.**

A CDC must be a non-profit corporation (or limited liability company) in good standing. (For-profit CDCs certified by SBA prior to January 1, 1987 may retain their certifications.) An SBIC may not become a CDC.

#### **§ 120.821 CDC Area of Operations.**

A CDC must have a designated Area of Operations, specified by the CDC and approved by SBA. There can be only one statewide CDC in each state, which must foster economic development throughout the state and provide 504 assistance to areas not adequately served by other CDCs.

#### **§ 120.822 CDC membership.**

A CDC must have at least 25 members (or stockholders for for-profit CDCs approved prior to January 1, 1987). No person or entity may own or control more than 10 percent of the CDC's voting membership (or stock). Members must be representative of and provide evidence of active support in the Area of Operations. Members must be from each of the following groups:

(a) Government organizations responsible for economic development in the Area of Operations and acceptable to SBA;

(b) Financial institutions that provide commercial long-term fixed asset financing in the Area of Operations;

(c) Community organizations dedicated to economic development in the Area of Operations such as chambers of commerce, foundations, trade associations, colleges, or universities; and

(d) Businesses in the Area of Operations.

#### **§ 120.823 CDC board of directors.**

The CDC must have a Board of Directors chosen from the membership by the members, and representing at least three of the four membership groups. No single group shall control. The Board members must be responsible officials of the organizations they represent, and at least one must possess commercial lending experience. The Board must meet at least quarterly and shall be responsible for CDC staff decisions and actions. A quorum shall require at least 5 Directors. If there is a vote on loan approval or servicing actions, at least one Board member with commercial loan experience approved by SBA must be present and vote. As an alternative, the Board may obtain the recommendation of another person approved by SBA and possessing commercial lending experience.

#### **§ 120.824 Professional management and staff.**

A CDC must have full-time professional management, including an Executive Director (or the equivalent) managing daily operations. It must also have a full-time professional staff qualified by training and experience to market the 504 Program, package and process loan applications, close loans, service the loan portfolio, and sustain a sufficient level of service and activity in the Area of Operations.

(a) *Contracting out to third parties.* CDCs may obtain, under contract, marketing, packaging, processing, and servicing services from qualified Service Providers located in the Area of Operations, subject to SBA's prior

written approval. CDCs may contract for outside legal and accounting services without SBA approval. Compensation under all such contracts must be reasonable and customary for similar services in the Area of Operations. SBA may audit the contracts.

(b) *Contracting out to other CDCs.* CDCs may contract with other CDCs for specific services, subject to SBA's prior written approval.

**§ 120.825 Financial ability to operate.**

A CDC must be able to sustain its operations continuously, with reliable sources of funds (such as income from services rendered and contributions from government or other sponsors).

**§ 120.826 Basic requirements for operating a CDC.**

A CDC must operate in accordance with applicable statutes, regulations, policy notices, SBA's Standard Operating Procedures (SOPs), and the information in its application. It must supply to SBA current and accurate information about all certification and operational requirements, and maintain the records and submit the reports required by SBA.

**§ 120.827 Services a CDC provides to small businesses.**

(a) A CDC must operate in and adequately service its Area of Operations. It must market the 504 program, package and process 504 loan applications, and close and service 504 loans. A CDC's loan portfolio must be diversified by business sector.

(b) A CDC may help small businesses obtain financial and technical assistance from other sources, including preparing, closing, and servicing loans under contract with Lenders in SBA's 7(a) program.

(c) A CDC also may loan amounts to the Borrower equal to the value of all or part of the Borrower's contribution to a Project in the form of cash or land, including site improvements, previously acquired by the CDC.

**§ 120.828 The minimum level of CDC lending activity.**

Each full fiscal year, a CDC must provide at least the minimum number of 504 Loans set by SBA in an annual program announcement.

**§ 120.829 The Job Opportunity average a CDC must maintain.**

(a) A CDC's portfolio must reflect an average of one Job Opportunity per \$35,000 of 504 loan funding. The AA/FA may permit a CDC to average up to one per \$45,000 for good cause in:

- (1) Alaska;
- (2) Hawaii;

(3) Redevelopment areas as defined in 42 U.S.C. 3161;

(4) State designated urban jobs and enterprise zones;

(5) Empowerment Zones and Enterprise Communities; and

(6) Labor Surplus Areas listed in the Department of Labor's publication "Area Trends".

(b) A CDC must indicate in its annual report the Job Opportunities actually or estimated to be provided by each Project.

(c) If a CDC does not maintain the required average, it may retain its certification if it justifies to SBA's satisfaction its failure to do so in its annual report and shows how it intends to attain the required average.

**§ 120.830 Reports a CDC must submit.**

A CDC must submit the following reports to SBA:

(a) An annual report within 90 days after the end of the CDC's fiscal year, and such interim reports as SBA may require;

(b) Resumes for all new Associates and staff;

(c) Reports of involvement in any legal proceeding;

(d) Changes in organizational status;

(e) Changes in any condition that affects its eligibility to continue to participate in the 504 program; and

(f) Quarterly service reports on each loan in its portfolio which is 60 days or more past due (and interim reports upon request by SBA).

**§ 120.831 Disclosure of referral fees or other payments by or to a CDC.**

The CDC must disclose to SBA and the Borrower any referral fees, remuneration, or payment made by the CDC to or received by the CDC from the Lender or any other party to the 504 transaction.

**Extending a CDC's Area of Operations**

**§ 120.835 Application to extend an Area of Operations.**

SBA may expand a CDC's Area of Operations for good cause shown including a showing that the proposed Area of Operations is not being served adequately by the existing CDCs and that the expanding CDC is well-qualified to serve it. SBA shall not consider an Area of Operations adequately served if the existing CDCs in the Area of Operation have not averaged, over the last two fiscal years, sufficient loan approvals for the population in the CDC's Area of Operations, as set by SBA in an annual program announcement. The CDC must apply in writing to the SBA District Office serving the geographic area in

which the CDC proposes to expand. The District Office shall submit its recommendation to the AA/FA for final decision.

**§ 120.836 Public notice of application for extension.**

SBA must notify all CDCs servicing the proposed area of expansion, allowing at least 30 days for comment. The CDC also must publish a notice in a general circulation newspaper in the proposed area of expansion, giving the public at least 30 days to comment.

**§ 120.837 Expiration of existing, temporary expansions.**

All existing, temporary expansions of Areas of Operation shall expire 6 months after the effective date of the final regulations, unless a CDC applies for permanent expansion before the expiration date.

**§ 120.838 Case by case extensions.**

(a) A CDC may apply to make an individual loan for a Project outside its Area of Operations in an area not adequately served by other CDCs to the District Office serving the area in which the Project will be located. The District Director may approve the request for good cause shown.

(b) A Borrower may request the services of a CDC not presently servicing its area by writing to the AA/FA.

**Accredited Lenders Program (ALP)**

**§ 120.840 Accredited Lenders Program.**

The SBA may designate a CDC as an Accredited Lender. SBA will provide an Accredited Lender with expedited loan processing or servicing action (within three days of receiving a completed application).

(a) *Applications.* CDCs may apply to the SBA field office with which it is most active. The SBA office will send its recommendation and the application to the AA/FA.

(b) *Eligibility.* SBA will consider the CDC's ability to work with the local SBA office and the quality of past performance.

(c) *Term of designation.* CDCs will be designated as ALPs for a two year period, and are eligible to renew the designation for additional two year periods.

(d) *Suspension and revocation.* The AA/FA may suspend or revoke ALP designation upon written notice stating the reasons therefore at least 10 business days prior to the effective date of the suspension or revocation. Reasons for suspension or revocation may include loan performance unacceptable to SBA or violations of applicable statutes,

regulations or published SBA policies and procedures. An ALP may appeal the suspension or revocation made under this section pursuant to the procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

#### Premier Certified Lenders Program

##### **§ 120.845 Premier Certified Lenders Program.**

The SBA has established a pilot program to designate a number of CDCs as Premier Certified Lenders ("PCLPs"), which will be able to process, approve, close and service 504 loans.

(a) *Characteristics.* Loans processed through the PCL Program will be subject to the same provisions as other 504 loans, including final approval by SBA.

(b) *Applications.* A CDC may obtain information concerning this program from SBA's Office of Pilot Operations in Washington, D.C. A CDC may apply to the SBA field office with which it is most active. The SBA office will send the application with a recommendation to the AA/FA.

(c) *Eligibility.* SBA will consider the CDC's ability to work with the local SBA office and the quality of past performance.

(d) *Loss reserve.* A PCLP must establish a loss reserve, secured by its segregated assets in favor of SBA, in the amount of the PCLP's historic loss rate or 10 percent of its exposure under the PCLP program, whichever is greater. The PCLP must contribute to the loss reserve every time a Debenture is issued, in intervals set by SBA.

(e) *Review.* The SBA shall review a PCLP's financings at least annually.

(f) *Suspension and revocation.* The AA/FA may suspend or revoke PCLP designation upon written notice stating the reasons therefore at least 10 business days prior to the effective date of the suspension or revocation. Reasons for suspension or revocation may include loan performance unacceptable to SBA, failure to meet loss reserve or eligibility criteria, or violations of applicable statutes, regulations or published SBA policies and procedures. A PCLP may appeal the suspension or revocation made under this section pursuant to the procedures set forth in part 134 of this title. The action of the AA/FA shall remain in effect pending resolution of the appeal.

(g) *Program period.* On October 1, 1997, the PCLP pilot program ends.

#### Associate Development Companies (ADCs)

##### **§ 120.850 ADC functions.**

(a) An ADC must support local economic development efforts. An ADC

may package, close, and service loans for a CDC under a written contract approved by SBA. Such contracts must meet Service Provider criteria, and specify the rights and responsibilities of the parties (including payment terms). The CDC remains solely responsible to SBA for the processing, closing, and servicing of the loan. It may not charge the Borrower a higher fee because it is using the ADC's services.

(b) An ADC must operate in accordance with statutes, regulations, policy notices, SBA's Standard Operating Procedures (SOPs), and the information in its application. It must supply to SBA current and accurate information about all certification and operational requirements, and maintain the records required by SBA.

##### **§ 120.851 ADC eligibility and operating requirements.**

(a) An ADC must demonstrate to SBA and maintain the following:

(1) Adequate management ability;

(2) A Board of Directors meeting at least quarterly and chosen from the membership by the members;

(3) A professional staff, including at least one qualified full-time professional with small business lending experience available during regular business hours; and

(4) A budget or financial statements showing the financial capability and funding to sustain continuing operations.

(b) An ADC may contract out for staff services only if SBA gives prior approval. The contract, subject to SBA audit, may not be self-serving, and compensation must be reasonable and customary.

##### **§ 120.852 Suspension and revocation of ADCs.**

SBA may require corrective action, or the AA/FA may suspend or revoke ADC status upon written notice stating the reasons therefore at least 10 business days prior to the effective date of the suspension or revocation. Reasons for suspension or revocation may include violations of applicable statutes, regulations or published SBA policies and procedures. An ADC may appeal the suspension or revocation made under this section pursuant to the procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal.

#### Ethical Requirements

##### **§ 120.855 CDC and ADC ethical requirements.**

CDCs and ADCs and their Associates must act ethically and exhibit good

character. They must meet all of the ethical requirements of § 120.140. In addition, they are subject to the following:

(a) Any benefit flowing to an Associate or the Associate's employer from the Associate's activities as an Associate shall be merely incidental (this requirement does not prevent an Associate or an Associate's employer from engaging in a business relationship with the CDC and/or the Borrower in the regular course of business, including providing interim financing or Third-Party loans); and

(b) Unless waived by SBA, an Associate may not be an officer, director, or manager of more than one CDC or ADC (except that the membership or Board of Directors of a broader-based CDC may include a member or director of a local CDC within its Area of Operations).

#### Project Economic Development Goals

##### **§ 120.860 Required objectives.**

A Project must achieve at least one of the economic development objectives set forth in § 120.861 or § 120.862.

##### **§ 120.861 Job creation or retention.**

A Project must create or retain one Job Opportunity for every \$35,000 guaranteed by SBA.

##### **§ 120.862 Other economic development objectives.**

A Project that achieves any of the following community development or public policy goals is eligible if the CDC's overall portfolio of 504 loans, including the subject loan, meets or exceeds the CDC's required Job Opportunity average. Applications for assistance must indicate how the Project will meet the specified economic development objective.

(a) Community Development goals:

(1) Improving, diversifying or stabilizing the economy of the locality;

(2) Stimulating other business development;

(3) Bringing new income into the community; or

(4) Assisting manufacturing firms (Standard Industrial Classification Manual (SIC) Codes 20-49).

(b) Public Policy goals:

(1) Revitalizing a business district of a community with a written redevelopment plan;

(2) Expanding exports;

(3) Expanding Minority Enterprise development (See § 124.103(b) of this chapter.);

(4) Aiding rural development;

(5) Increasing productivity and competitiveness (retooling, robotics, modernization, competition with imports);

(6) Modernizing or upgrading facilities to meet health, safety, and environmental requirements;

(7) Assisting businesses affected by Federal budget reductions, such as base closings; or

(8) Assisting businesses in Labor Surplus Areas as defined by the Department of Labor.

#### Leasing Policies Specific to 504 Loans

##### § 120.870 Leasing Project Property.

(a) A Borrower may use the proceeds of a 504 loan to acquire, construct, or modify buildings and improvements, and/or to purchase and install machinery and equipment located on land leased to the Borrower by the CDC or an unrelated lessor if:

(1) The remaining term of the lease, including options to renew, exercisable solely by the lessee, equals or exceeds the term of the Debenture, or, in the case of machinery or equipment, equals or exceeds the useful life of the property or the term of the Debenture, whichever is lesser;

(2) The Borrower assigns its interest in the lease to the CDC with right of reassignment to SBA; and

(3) The 504 loan is secured by a recorded lien against the leasehold estate and other collateral as necessary.

(b) If a CDC leases property to a small business, the rent paid by the small business during the term of the Debenture must be enough to pay principal and interest on all debt incurred by the CDC to finance the Project, and all related expenses. The rent also may include a reasonable return on the CDC's investment.

##### § 120.871 Leasing part of a new construction Project to another business.

If a Project is the construction of a new building, a Borrower may lease up to 33% of the square footage of the rentable property (total square footage of all buildings or facilities used for business operations) for a short term to any third party if reasonable growth projections show that the Borrower will need additional space within three years and will use all of the additional space within ten years. If the Borrower is an Eligible Passive Company leasing 100 percent of the Project space to an Operating Company, the Operating Company may sublease up to 33 percent to a third party under the same conditions.

##### § 120.872 Leasing part of an existing building to another business.

If a Project involves the acquisition, renovation, or reconstruction of an existing building, the Borrower (or Operating Company) must occupy at

least 51 percent of the Rentable Property. The balance of the Rentable Property may be leased out to any third party, if the 504 loan proceeds were not used to remodel or convert the space to be leased out. The costs of interior finishing of the space to be leased out are not eligible Project costs, and third-party loan proceeds used to renovate the leased space shall not count towards the 504 first mortgage requirement or the Borrower's contribution.

#### Loan-Making Policies Specific to 504 Loans

##### § 120.880 Basic eligibility requirements.

In addition to the eligibility requirements specified in subpart A, to be an eligible Borrower for a 504 loan, a small business must:

(a) Use the Project Property (except for loans to Passive Companies); and

(b) Together with its affiliates, meet one of the following size standards:

(1) It does not have a net worth in excess of \$6 million, and does not have an average net income after Federal income taxes (excluding any carry-over losses) for the preceding two years in excess of \$2 million; or

(2) It meets the size standards in Part 121 of this chapter for the industry in which it is primarily engaged.

##### § 120.881 Ineligible Projects for 504 loans.

In addition to the ineligible businesses and uses of proceeds specified in subpart A of this part, the following Projects are ineligible for 504 financing:

(a) Relocation of any of the operations of a small business which will cause a Substantial Increase in Unemployment, unless the CDC can justify the loan because:

(1) The relocation is for key economic reasons and crucial to the continued existence, economic wellbeing, and/or competitiveness of the applicant; and

(2) The economic development benefits to the applicant and the receiving community outweigh the negative impact on the community from which the applicant is moving;

(b) Projects in foreign countries (loans financing real or personal property located outside the United States or its possessions); and

(c) Speculative Projects (such as oil wildcatting).

##### § 120.882 Eligible Project costs for 504 loans.

Eligible Project costs which may be paid with the proceeds of 504 loans are:

(a) Costs directly attributable to the Project including expenditures incurred by the Borrower (with its own funds or from a loan):

(1) To acquire land used in the Project prior to applying to SBA for the 504 loan; or

(2) For any other expense toward a Project within six months of receipt by SBA of a complete loan application;

(b) In construction Projects, a contingency reserve for cost overruns not to exceed 10 percent of construction cost;

(c) Professional fees directly attributable and essential to the Project, such as title insurance, architecture, engineering, accounting, legal fees and environmental studies; and

(d) Repayment of interim financing including points, fees and interest.

##### § 120.883 Eligible administrative costs for 504 loans.

The following costs and fees are not part of Project costs but may be paid with the proceeds of the 504 loan and the Debenture:

(a) SBA guarantee fee;

(b) Funding fee (to cover cost of public issuance of securities);

(c) CDC processing fee;

(d) Closing costs, including legal fees; and

(e) Underwriters fee.

##### § 120.884 Ineligible costs for 504 loans.

Costs not directly attributable and necessary for the Project may not be paid with proceeds of the 504 loan. These include, but are not limited to, the following:

(a) Debt refinancing (other than interim financing);

(b) Third-Party Loan fees (commitment, broker, finders, origination, processing fees of permanent financing);

(c) Ancillary business expenses, such as:

(1) Working capital;

(2) Counseling or management services fees;

(3) Incorporation/organization costs;

(4) Franchise fees; and

(5) Advertising;

(d) Non fixed-asset project components, such as:

(1) Short-term equipment, furniture, and furnishings (unless essential to and a minor portion of the Project);

(2) Automobiles, trucks, and airplanes; and

(3) Construction equipment (except for heavy duty construction equipment integral to a business' operations and meeting the IRS definition of capital equipment).

#### Interim Financing

##### § 120.890 Source of interim financing.

A Project may use interim financing for all Project costs except the

Borrower's contribution. Any source (including a CDC) may supply interim financing provided:

- (a) The financing is not derived from any SBA program, directly or indirectly;
- (b) The terms and conditions of the financing are acceptable to SBA;
- (c) The source is not the Borrower or an Associate of the Borrower; and
- (d) The source has the experience and qualifications to monitor properly all construction and progress payments. (If the source lacks such experience or qualifications, SBA may require the interim loan to be managed by a third party such as a bank or professional construction manager.)

**§ 120.891 Certifications of disbursement and completion.**

Before the Debenture is issued, the interim lender must certify that the interim financing has been disbursed in a manner consistent with the terms of the Authorization. Also, the CDC must certify that the Project was completed in accordance with the final plans and specifications (except as provided in § 120.962).

**§ 120.892 Certifications of no adverse change.**

Following completion of the Project, the following certifications must be made before the 504 loan closing:

- (a) The interim lender must certify to the CDC that it has no knowledge of any adverse change in the condition of the small business since the application;
- (b) The Borrower (or Operating Company) must certify to the CDC that there has been no adverse change in its financial condition or its ability to repay the 504 loan since the date of application, and must furnish interim financial statements, current within 90 days of closing; and
- (c) The CDC must issue an opinion to the best of its knowledge that there has been no adverse change in the Borrower's (or Operating Company's) ability to repay the 504 loan since SBA's approval of the loan application.

**Permanent Financing**

**§ 120.900 What are the sources of permanent financing?**

Permanent financing for each Project must come from three sources: the Borrower's contribution, Third-Party Loans, and the 504 loan. Typically, the Borrower contributes 10 percent of the permanent financing, Third-Party Loans 50 percent and the 504 loan 40 percent.

**The Borrower's Contribution**

**§ 120.910 How much must the Borrower contribute?**

The Borrower must contribute to the Project cash (or property acceptable to SBA obtained with the cash) or land (that is part of the Project Property) valued at 10 percent or more of the Project cost (exclusive of administrative cost). The source of the contribution may be a CDC or any other source except an SBA business loan program (see § 120.913 for SBIC exception).

**§ 120.911 Land contributions.**

The Borrower's contribution may be land, including site improvements, previously acquired by the Borrower or the CDC. The amount of the contribution shall be the value of the contributor's equity in the land, excluding the value of any structures, under SBA's policy guidelines.

**§ 120.912 Borrowed contributions.**

The Borrower may borrow its cash contribution from the CDC or a third party. If any of the contribution is borrowed, the interest rate must be reasonable. If the loan is secured by any of the Project assets, the loan must be subordinate to the liens securing the 504 Loan, and the loan may not be repaid at a faster rate than the 504 Loan unless SBA gives prior written approval. A third party lender may not receive voting rights, stock options, or any other actual or potential voting interest in the small business.

**§ 120.913 May an SBIC provide the contribution?**

Subject to part 107 of this chapter, SBIC's may provide financing for all or part of the Borrower's contribution to the project. SBA shall consider SBIC funds to be derived from federal sources if the SBIC has leverage (as defined in part 107 of this chapter). If the SBIC does not have leverage, the investment will be considered to be from private funds. SBIC financing must be subordinated to the 504 loan and may not be repaid at a faster rate than the Debenture.

**Third Party Loans**

**§ 120.920 The first lien position.**

The Borrower must obtain one or more Third Party Loans totaling at least as much as the 504 loan. Third Party Loans usually have the first lien position. They cannot be guaranteed by SBA.

**§ 120.921 Terms of Third Party loans.**

(a) *Maturity.* A Third Party Loan must have a term of at least 7 years when the 504 loan is for a term of 10 years and

10 years when the 504 loan is for 20 years. If there is more than one Third Party Loan, an overall loan maturity must be calculated, taking into account the maturities and amounts of each loan. If there is a balloon payment, it must be justified in the loan report and clearly identified in the Loan Authorization.

(b) *Interest rates.* Interest rates must be reasonable. SBA must establish and publish in the Federal Register a maximum interest rate for any Third Party Loan from commercial financial institutions. The rate shall remain in effect until changed.

(c) *Other terms.* The Third Party Loan must not have any early call feature or contain any demand provisions unless the loan is in default. By participating, a Third Party Loan lender waives, as to the CDC/SBA financing, any provision in its deed of trust, or mortgage, or other documents prohibiting further encumbrances or subordinate debt. In the event of default, the Third Party Lender must give the CDC and SBA written notice of default within 30 days of the event of default and at least 60 days prior to foreclosure.

**§ 120.922 Pre-existing debt on the Project Property.**

In addition to its share of Project cost, a Third Party Loan may include consolidation of existing debt on the Project Property. The consolidation must not improve the lien position of the Lender on the pre-existing debt, unless the debt is a previous Third Party Loan.

**§ 120.923 What are the policies on subordination?**

(a) Financing provided by the seller of Project Property must be subordinate to the 504 loan. SBA may waive the subordination requirement if the property is classified as "other real estate owned" by a national bank or other Federally regulated lender and SBA considers the property to be of sufficient value to support the 504 loan.

(b) By participating, Third Party Loan lienholders subordinate to the CDC/SBA lien future advances in excess of the Third Party Loans except expenditures for collection, maintenance, and protection of the Third Party Loan lienholder's lien position.

(c) A Borrower is eligible for a 504 loan even if part of the Project financing is tax-exempt. SBA's lien position must not be subordinate to loans made from the proceeds of the tax-exempt obligation.

**§ 120.924 Prepayment of subordinate financing.**

The Borrower must not prepay any Project financing subordinate to the 504 loan without SBA's prior written consent.

**§ 120.925 Preferences.**

No Third Party Lender shall establish a Preference.

**504 Loans and Debentures****§ 120.930 Amount.**

(a) Generally, a 504 loan may not exceed 40 percent of total Project cost plus 100 percent of eligible administrative costs. For good cause shown, SBA may authorize an increase in the percentage of Project costs covered up to 50 percent. No more than 50 percent of eligible Project costs can be from Federal sources, whether received directly or indirectly through an intermediary.

(b) Generally, the minimum 504 loan must be \$50,000, although, upon good cause shown, SBA may permit a 504 loan as small as \$25,000. The amount of the Debenture must equal the amount of the 504 Loan. If the cost of the completed Project is less than 98 percent of the authorized Debenture amount, the amount of the Debenture to be issued shall be reduced by the difference. If the cost of the completed project is at least 98 percent of the authorized Debenture amount, the full authorized amount of the Debenture shall be disbursed.

**§ 120.931 504 lending limits.**

The outstanding balance of all SBA financial assistance to a Borrower and its affiliates under the 504 program covered by this Part must not exceed \$750,000 (\$1,000,000 if one or more of the public policy goals enumerated in § 120.861(b) applies to the Project).

**§ 120.932 Interest rate.**

The interest rate of the 504 Loan and the Debenture which funds it is set by the Underwriter and approved by the Secretary of the Treasury. Each 504 loan must have a fixed interest rate.

**§ 120.933 Maturity.**

The term of a 504 Loan and the Debenture which funds it shall be either 10 or 20 years.

**§ 120.934 Collateral.**

The CDC/SBA takes at least a second lien position on the Project collateral. In rare circumstances, collateral other than the Project collateral may be accepted by SBA. Sometimes secondary collateral is required. All collateral must be insured against such hazards and risks

as SBA may require, with provisions for notice to SBA and the CDC in the event of impending lapse of coverage.

**§ 120.935 Deposit.**

At the time of application for a 504 loan, the CDC may require a deposit from the Borrower of \$2,500 or 1 percent of the Net Debenture Proceeds, whichever is less. The deposit may be applied to the loan processing fee if the application is accepted, but must be refunded if the application is denied. If the small business withdraws its application, the CDC may deduct from the deposit reasonable costs incurred in packaging and processing the application.

**§ 120.936 Subordination to CDC.**

SBA, in its sole discretion, may permit subordination of the Debenture to any other obligation of the CDC, except debt incurred by the CDC to obtain funds to loan to the Borrower for the Borrower's required contribution to the Project financing.

**§ 120.937 Assumption.**

A 504 loan may be assumed with SBA's prior written approval.

**§ 120.938 Default.**

(a) Upon occurrence of an event of default specified in the 504 note which requires automatic acceleration, the note becomes due and payable. Upon occurrence of an event of default which does not require automatic acceleration, SBA may forbear acceleration of the note and attempt to resolve the default. If the default is not cured subsequently, the note shall be accelerated. In either case, upon acceleration of the note, the Debenture which funded it is also due immediately, and SBA must honor its guarantee of the Debenture. SBA shall not reimburse the investor for any premium paid.

(b) If a CDC defaults on a Debenture, SBA generally shall limit its recovery to the payments made by the small business to the CDC on the loan made from the Debenture proceeds, and the collateral securing the defaulted loan. However, SBA will look to the CDC for the entire amount of the Debenture in the case of fraud or negligence by the CDC.

**§ 120.939 Borrower prohibition.**

Neither a 504 loan recipient nor its Small Business Associate may purchase the Debenture that funded its 504 loan.

**§ 120.940 Prepayment of the 504 loan or Debenture.**

The Borrower may prepay its 504 loan, if it pays the entire principal balance, unpaid interest, any unpaid

fees, and any prepayment premium established in the note. If the Borrower prepays, the CDC must prepay the corresponding Debenture with interest and premium. If one of the Debentures in a Debenture Pool is prepaid, Certificate holders must be paid pro rata, and SBA's guarantee on the entire Debenture Pool must be proportionately reduced. If the entire Debenture Pool is paid off, SBA may call all Certificates backed by the Pool for redemption.

**§ 120.941 Certificates.**

(a) The face value of a Certificate must be at least \$25,000. Certificates are issued in registered form and transferred only by entry on the central registry maintained by the Trustee. No transfer may take place within 10 business days of a payment date. SBA guarantees the timely payment of principal and interest on the Certificates.

(b) Before the sale of a Certificate, the seller, or the broker or dealer acting as the seller's agent, must disclose to the purchaser the terms, conditions, yield, and premium and other characteristics not guaranteed by SBA.

**Debenture Sales and Service Agents****§ 120.950 SBA and CDC must appoint agents.**

SBA and the CDC must appoint the following agents to facilitate the sale and service of the Certificates and disbursement of the proceeds.

**§ 120.951 Selling agent.**

The CDC, with SBA approval, shall appoint a Selling Agent to select underwriters, negotiate the terms and conditions of Debenture offerings with the underwriters, and direct and coordinate Debenture sales.

**§ 120.952 Fiscal agent.**

SBA shall appoint a Fiscal Agent to assess the financial markets, minimize the cost of sales, arrange for the production of the Offering Circular, Debenture Certificates, and other required documents, and monitor the performance of the transfer agent and the underwriters.

**§ 120.953 Trustee.**

SBA must appoint a Trustee (known as a Transfer Agent for the December 1986 Debenture sale) to:

- (a) Issue Certificates;
- (b) Transfer the Certificates upon resale in the secondary market;
- (c) Maintain physical possession of the Debentures for SBA and the Certificate holders;
- (d) Establish and maintain a central registry of:

(1) Debenture Pools, including the CDC obligors and the interest rate payable on the Debentures in each Pool;

(2) Certificates issued or transferred, including the Debenture Pool backing the Certificate, name and address of the purchaser, price paid, the interest rate on the Certificate, and fees or charges assessed by the transferrer; and

(3) Brokers and dealers in Certificates, and the commissions, fees or discounts granted to the brokers and dealers;

(e) Receive semi-annual Debenture payments and prepayments;

(f) Make regularly scheduled and prepayment payments to Registered Holders of Debentures or Certificates; and

(g) Assure before any resale of a Debenture or Certificate is recorded in the registry that the seller has provided the purchaser a written disclosure statement approved by SBA.

#### **§ 120.954 Central Servicing Agent.**

(a) SBA has entered into a Master Servicing Agreement designating a Central Servicing Agent (CSA) to support the orderly flow of funds among Borrowers, investors, CDCs, and SBA. The CDC and Borrower must enter into an individual Servicing Agent Agreement with the CSA for each 504 loan, constituting acceptance by the CDC and the Borrower of the terms of the Master Servicing Agreement.

(b) The CSA has established a master reserve account. All funds related to the 504 loans and Debentures flow through the master reserve account under the provisions of the Master Servicing Agreement. The master reserve account shall be funded by a reserve deposit, a funding fee to be published from time to time in the Federal Register, and by principal and interest payments of 504 loans. At SBA's direction, the CSA uses the funds in the master reserve account to defray program expenses. In the event a Borrower defaults and the 504 note is accelerated, SBA shall add funds under its guarantee to ensure the full and timely payment of the Debenture which funded the 504 loan. The CSA shall pay to the CDC servicing each loan the interest accruing in the master reserve account on loan payments made by each Borrower between the date of receipt of each monthly payment and the date of disbursement to investors. The CSA may disburse such interest periodically to CDCs on a pro rata basis. SBA may use interest accruals in the account earned prior to October 1991 on such payments (not previously distributed to the CDCs) for 504 program administration.

#### **§ 120.955 Agent bonds and records.**

(a) Each agent (in §§ 120.951–120.955) must provide a fidelity bond or insurance in such amount as necessary to fully protect the interest of the government.

(b) SBA must have access at the agent's place of business to all books, records and other documents relating to Debenture activities.

#### **§ 120.956 Suspension or revocation of brokers and dealers.**

The AA/FA may suspend or revoke the privilege of any broker or dealer to participate in the sale or marketing of Debentures and Certificates for actions or conduct bearing negatively on the broker's fitness to participate in the securities market. SBA must give the broker or dealer written notice, stating the reasons therefore, at least 10 business days prior to the effective date of the suspension or revocation of ADC status. A broker or dealer may appeal the suspension or revocation made under this section pursuant to the procedures set forth in part 134 of this chapter. The action of the AA/FA shall remain in effect pending resolution of the appeal. SBA may suspend or revoke of the opportunity for a hearing under part 134 of this chapter.

#### **Closings**

#### **§ 120.960 Responsibility for closing.**

The CDC is responsible for the 504 Loan closing. The Debenture closing is the joint responsibility of the CDC and SBA.

#### **§ 120.961 CDC closing fees.**

(a) The CDC may charge the Borrower an amount sufficient to reimburse it for reasonable legal fees related to closing the 504 loan. The legal fees and other professional fees and closing costs are administrative costs eligible for reimbursement from the debenture proceeds.

(b) The CDC may charge a finder's fee of up to 1.5 percent of the 504 loan if the CDC secured the lender for the Borrower under a written contract. Either the Borrower or the lender may pay the fee. It may not be reimbursed from the Debenture proceeds.

#### **§ 120.962 Construction escrow accounts.**

The CSA, title company, or bank may hold Debenture proceeds in escrow to complete Project components such as landscaping and parking lots, and acquire machinery and equipment if the component or acquisition is a minor portion of the total Project and has been contracted for completion or delivery at a specified price and specific future date. The escrow agent must disburse

funds upon approval by the CDC and the SBA, supported by invoices and payable jointly to the small business and the designated contractor.

#### **Servicing and Post-Closing Fees**

#### **§ 120.970 Servicing of 504 loans and Debentures.**

The CDC must service the 504 loan in accordance with the Loan Authorization, these regulations, SBA policies and procedures, and prudent lending standards until paid in full, including review of the small business's financial statements, tax filings, insurance, and security filings. CDCs must comply with the provisions of § 120.513. In addition, the CDC must comply with the servicing requirements set forth in SBA's SOP. The CDC must report promptly to SBA any adverse trend, condition or information. Upon request by a CDC, SBA may agree to defer a Borrower's monthly payment. SBA may negotiate agreements with CDCs to liquidate loans.

#### **§ 120.971 Post-closing fees paid by Borrower.**

(a) *CDC fees.* CDCs may charge the following fees to the Borrower:

(1) *Service fee.* A service charge of not less than 0.5 percent nor more than 2 percent per annum on the outstanding balance of the 504 loan measured at 5 year anniversary intervals. A service charge in excess of 1.5 percent in a Rural Area and 1 percent everywhere else requires SBA's prior written approval, based on evidence of substantial need. The CDC's monthly service fee shall be paid only from loan payments received. The fees may be accrued without interest and collected from the CSA when the payments are made;

(2) *Late fees.* Payments received after the 15th of each month may be subject to a late payment fee of 5 percent of the late payment or \$100, whichever is greater, collected by the CSA on behalf of the CDC; and

(3) *Assumption fee.* Upon SBA's written approval, a CDC may charge an assumption fee equal to no more than 1 percent of the outstanding principal balance of the loan being assumed.

(b) *CSA fees.* The CSA may charge an initiation fee on each loan and a monthly service fee under the terms of the Master Servicing Agreement.

(c) *Other agent fees.* Agent fees and charges necessary to market and service Debentures and Certificates may be assessed to the Borrower or the investor. The fees must be approved by SBA and published periodically in the Federal Register.

(d) *SBA fees.* The Borrower shall pay SBA an annual fee of 0.125 percent of the outstanding balance of each 504 loan approved after October 1, 1995.

**§ 120.972 Oversight and evaluation of CDCs and ADCs.**

SBA may conduct an operational review of a CDC or ADC. The SBA Office of Inspector General may conduct, supervise or coordinate compliance audits pursuant to the Inspector General Act. The CDC or ADC must cooperate and make its staff, records, and facilities available.

CDC Transfer, Suspension and Revocation

**§ 120.980 Transfer of CDC to ADC status.**

SBA shall transfer to ADC status any CDC that fails to meet the activity level required by SBA, on average over two consecutive fiscal years. SBA shall notify the CDC in writing of the action and of the opportunity for a hearing pursuant to part 134 of this chapter at least 10 business days prior to the transfer. During the pendency of a hearing, SBA's action will remain in effect.

**§ 120.981 Voluntary transfer and surrender of CDC certification.**

A CDC may not transfer its certification or withdraw from the 504 program without SBA's consent. The CDC must provide a plan to SBA to transfer its portfolio. The portfolio may only be transferred with SBA's written consent. If a CDC desires to withdraw from the 504 program, it must forfeit its portfolio to SBA. SBA may conduct an audit of the transferring or withdrawing CDC.

**§ 120.982 Correcting CDC servicing deficiencies.**

SBA may require corrective action, including the transfer of existing or pending financings to another CDC in good standing. SBA must notify the CDC in writing of any servicing, reporting or collection deficiencies and the corrective actions to be taken. SBA may instruct the CSA to withhold service and late fees and may assess the CDC up to \$250 per day for expenses incurred by SBA to correct the deficiencies. If non-compliance continues for 90 days, SBA may take the fees as compensation for its efforts to obtain compliance.

**§ 120.983 Transfer of CDC servicing to SBA or another CDC.**

If a CDC fails to correct servicing deficiencies, or is unable or unwilling to service its portfolio, SBA may assume the servicing or require the transfer of all or part of the CDC's portfolio to another CDC within or adjoining the

deficient CDC's Area of Operations. If there is no suitable CDC, SBA may approve a transfer to another entity. Future service fees from transferred loans will be paid to the transferee. In addition, the CDC's processing authority will be temporarily suspended.

**§ 120.984 Suspension or revocation of CDC certification.**

(a) *Suspend or revoke.* SBA may suspend or revoke the CDC's certification if a CDC:

(1) Violates a statute, an SBA regulation, or the terms of a Debenture, authorization, or agreement with SBA;

(2) Makes a material false statement, knowingly misrepresents, or fails to state a material fact;

(3) Fails to maintain good character;

(4) Fails to operate according to prudent lending standards;

(5) Fails to correct servicing, collection, reporting, or other deficiencies; or

(6) Is unable or unwilling to operate in accordance with the requirements of this part.

(b) *Transfer portfolio.* Upon suspension or revocation, the CDC must transfer its remaining portfolio and any 504 applications or financings in process to another CDC designated or approved by SBA. If a pending 504 financing is completed after a transfer, any deposit must also be transferred. Any fees must be apportioned by SBA between the two CDCs in proportion to services performed.

(c) *Provide written notice.* SBA must give written notice to the CDC at least 10 business days prior to the effective date of a suspension or revocation, informing the CDC of the opportunity for a hearing pursuant to part 134 of this chapter.

Enforceability of 501, 502 and 503 Loans and Other Laws

**§ 120.990 501, 502, and 503 loans.**

SBA has discontinued loan programs for 501, 502, and 503 loans. Outstanding loans remain under these programs, and Borrowers, CDCs, and SBA must comply with the terms and conditions of the corresponding notes and Debentures, and the regulations in effect when the obligations were undertaken or last in effect, if applicable.

**§ 120.991 Effect of other laws.**

No State or local law may preclude or limit SBA's exercise of its rights with respect to notes, guarantees, Debentures and Debenture Pools, or of its enforcement rights to foreclose on collateral.

**PARTS 108, 116, 122, AND 131—  
[REMOVED]**

2. Parts 108, 116, 122, and 131 are removed.

Dated: November 13, 1995.

Philip Lader,

Administrator.

[FR Doc. 95-30327 Filed 12-14-95; 8:45 am]

BILLING CODE 8025-01-P

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

[EE-34-95]

RIN 1545-AT78

**Notice of Significant Reduction in the Rate of Future Benefit Accrual**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking by cross-reference to temporary regulations.

**SUMMARY:** In the Rules and Regulations section of this issue of the Federal Register, the IRS is issuing temporary regulations relating to the requirements of section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Section 204(h) of ERISA applies to defined benefit plans and to individual account plans that are subject to the funding standards of section 302 of ERISA. It requires the plan administrator to give notice of certain plan amendments to participants in the plan and certain other parties. The text of those temporary regulations also serves as the text of these proposed regulations.

**DATES:** Written comments must be received by March 14, 1996.

**ADDRESSES:** Send submissions to CC:DOM:CORP:R (EE-34-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (EE-34-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington DC.

**FOR FURTHER INFORMATION CONTACT:** Betty J. Clary, (202) 622-6070 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

Paperwork Reduction Act

The collection of information contained in this notice of proposed