Reporting and recordkeeping requirements, Transportation.

Accordingly, we are adopting as a final rule, without change, the regulations at 7 CFR 301.50 through 301.50–10, as established and amended by interim rules published at: 57 FR 54492–54499 on November 19, 1992; at 58 FR 6346–6348 on January 28, 1993; at 58 FR 28333–28335 on May 13, 1993; at 58 FR 34681–34683 on June 29, 1993; at 58 FR 63024–63027 on November 30, 1993; at 59 FR 39937–39941 on August 5, 1994; at 59 FR 52891–52894 on October 20, 1994; and at 60 FR 2321–2323 on January 9, 1995.

Authority: 7 U.S.C. 150bb, 150dd, 150ee, 150ff, 161, 162, and 164–167; 7 CFR 2.22, 2.80, and 371.2(c).

Done in Washington, DC, this 25th day of January 1996.

Lonnie J. King,

Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 96–1855 Filed 1–30–96; 8:45 am]

BILLING CODE 3410–34–P

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R–0915]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of adjustment of dollar amount.

SUMMARY: The Board is publishing an adjustment to the dollar amount that triggers certain requirements of Regulation Z (Truth in Lending) for mortgages bearing fees above a certain amount. The Home Ownership and Equity Protection Act of 1994 sets forth rules for creditors offering home-secured loans with total points and fees payable by the consumer at or before loan consummation that exceed the greater of $400 or 8 percent of the total loan amount. The Board is required to annually adjust the $400 amount based on the annual percentage change in the Consumer Price Index as reported on June 1. The Board has adjusted the dollar amount from $400 to $412.

EFFECTIVE DATE: January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Michael Hentrel, Staff Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452–3667. For the users of Telecommunications Device for the Deaf only, please contact Dorothea Thompson at (202) 452–3544.

SUPPLEMENTARY INFORMATION:

Background

The Truth in Lending Act (TILA; 15 U.S.C. 1601—1666j) requires creditors to disclose credit terms and the cost of consumer credit as an annual percentage rate. The act requires additional disclosures for loans secured by a consumer's home, and permits consumers to cancel certain transactions that involve their principal dwelling. The TILA is implemented by the Board's Regulation Z (12 CFR part 226).

On March 24, 1995, the Board published amendments to Regulation Z implementing the Home Ownership and Equity Protection Act of 1994 (HOEPA), contained in the Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103–325, 108 Stat. 2160 (60 FR 15463). These amendments, which became effective on October 1, 1995, are contained in § 226.32 of the regulation and impose new disclosure requirements and substantive limitations on certain closed-end mortgage loans bearing rates or fees above a certain percentage or amount. Creditors are required to comply with the rules in § 226.32 if the total points and fees payable by the consumer at or before loan consummation exceed the greater of $400 or 8 percent of the total loan amount. The TILA and § 226.32(a)(1)(ii) of Regulation Z provide that the $400 figure shall be adjusted annually on January 1 by the annual percentage change in the Consumer Price Index (CPI) that was reported on the preceding June 1. See 15 U.S.C. 1602(aa).

The Bureau of Labor Statistics publishes consumer-based indices monthly, but does not ''report'' a CPI change on June 1; adjustments are reported in the middle of each month. The CPI–U is based on all urban consumers and represents approximately 80 percent of the U.S. population; the CPI–W is based on urban wage earners and clerical workers and represents about 30 percent of the population. The Board believes the index representing the broader population of U. S. consumers—the CPI–U—is the appropriate index to use in any adjustment to the $400 dollar figure.

The adjustment to the $400 dollar figure reflects the adjustment reported on May 15 (the rate ''in effect'' on June 1) which states the percentage increase from April 1994 to April 1995. During that period the CPI–U increased by 3.1 percent which would cause an adjustment of the $400 to $412.40. The Board is rounding that number to whole dollars for ease of compliance.

Adjustment

Effective January 1, 1996, under § 226.32(a), a home mortgage loan is covered by § 226.32 if the total points and fees payable by the consumer at or before loan consummation exceed the greater of $412 or 8 percent of the total loan amount. The adjustment will be codified in the official staff commentary to Regulation Z.

By order of the Board of Governors of the Federal Reserve System, January 25, 1995.

William W. Wiles,

Secretary of the Board.

[FR Doc. 96–1859 Filed 1–30–96; 8:45 am]

BILLING CODE 6210–01–P

SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

Small Business Investment Companies

AGENCY: Small Business Administration.

ACTION: Final rule.

SUMMARY: This final rule revises the regulations found at 13 CFR Part 107, governing the Small Business Investment Company (SBIC) Program. It eliminates inconsistencies, clarifies procedures, accommodates program experience and industry changes, and provides for more efficient program operation. It also clarifies and shortens regulations where appropriate, eliminates redundant provisions, consolidates and reorganizes sections and clarifies ambiguous language.

EFFECTIVE DATE: This final rule is effective January 31, 1996.

FOR FURTHER INFORMATION CONTACT: Leonard Fagan, Office of Investment; telephone no. (202) 205–6510.

SUPPLEMENTARY INFORMATION: In response to a Memorandum from President Clinton for all federal agencies to simplify their regulations, SBA published a proposed rule on November 28, 1995, to revise the regulations governing the SBIC program. See 60 FR 58530 (November 28, 1995). The public was afforded a thirty-day period in which to submit comments on the proposed rule to SBA. During that period, SBA received over 30 letters containing over 200 comments. After giving careful consideration to the comments and concerns raised in those letters, SBA is today finalizing the proposed rule with certain modifications discussed below. Only those sections which have changed, which were commented on or which

need some clarification will be discussed.

In accordance with 5 U.S.C. 553(d)(3), SBA has determined that good cause exists to make this rule effective upon publication. Ample notice of material changes has been given the interested public through proposed rules published in the Federal Register inviting public comment and through distribution of draft rules before publication of the proposed rules. All comments received from the interested public have been carefully considered. Representatives of the entities affected by this rule concur with an immediate effective date. Almost all regulatory changes will relieve restrictions or merely reorganize and simplify text. To the extent there are substantive changes contained in these rules, SBA believes no prejudice will occur to affected entities by making the rules immediately effective. The affected entities will have had an adequate opportunity to take any necessary steps to be in compliance with the rules by the effective date, but to the extent that may not be the case, any instance of non-compliance with a changed regulatory provision during the first 30 days after publication will be treated with such liberality as may be needed to avoid prejudice. New fees imposed through these rules will not be enforced until at least 30 days after publication.

General Comments

Those comment letters which addressed the proposed renumbering, reorganization and rewrite of Part 107 were overwhelmingly complimentary. Some felt the proposed regulations were a vast improvement over the old, while others commended SBA on its efforts to simplify and streamline the regulations. Most agreed that the reorganization and stylistic revisions will make Part 107 easier to follow and understand. As one commenter stated, ''Practicality and common sense really pervade these new proposals.''

Part I

1. Subpart A—Introduction to Part 107

SBA agrees with the comment received on proposed § 107.20, suggesting that it is unnecessary to specifically mention Section 301(d) Licensees when discussing the fact that all Licensees must comply with all applicable regulations. The section has been revised and finalized accordingly.

2. Subpart B—Definition of Terms Used in Part 107

a. ''Associate''

(1) Several commenters suggested that the proposed language defining ''any person regularly serving a Licensee in the capacity of attorney at law'' as an Associate was ambiguous and could be construed too broadly. SBA agrees and will return to the language in the current definition which states that an Associate includes ''any Person regularly serving a Licensee on retainer in the capacity of attorney at law''. The definition is finalized accordingly.

b. ''Control''

The proposed definition of ''Control'' has been adopted with a change suggested by one commenter. In the proposed rule, Control could be achieved through possession of the ''power to veto'' the direction of the management and policies of a concern; in the final rule, the reference to veto power is deleted. The commenter's concern was that this phrase could be interpreted so broadly as to prohibit normal covenants necessary to protect a Licensee's investments. This was not SBA's intention; furthermore the Agency believes that its concerns about negative Control of Small Businesses are sufficiently addressed by the reference in the definition to ''indirect'' Control, as well as by the ''presumption of Control'' provisions under § 107.865(b).

c. ''Control Person''

Under the existing regulations, a Person with at least a 40 percent limited partnership interest in a Licensee's general partner is a Control Person. Paragraph (4) of the proposed definition would apply the same criterion to a limited partner in the Licensee itself. One commenter objected to the entire concept of classifying a limited partner as a Control Person, suggesting that the provision contradicts established partnership principles and could threaten a limited partner's limited liability status. SBA does not believe that a regulatory definition would have this effect; furthermore, the Agency has stated previously that the definition of Control Person is intended to cover persons in a position to exercise influence, but not necessarily control, over a Licensee. Nevertheless, in response to the concern expressed, SBA has increased the ownership percentage required to classify a limited partner (of either a Licensee or its general partner) as a Control Person from 40 percent to 50 percent.

d. ''Disadvantaged Businesses''

SBA received one comment objecting to the proposed language requiring that a Disadvantaged Business be managed ''on a day to day basis'' by persons who meet the criteria for social or economic disadvantage. The commenter considered this phrase an unwarranted expansion of the definition. SBA disagrees; the requirement that disadvantaged owners be actively involved in the management of their companies reflects long-standing SBA policy and is consistent with the Agency's statutory mandate for all of its programs for Disadvantaged Businesses. Accordingly, the definition is finalized as proposed.

e. ''Equity Capital Investment''

SBA received one comment suggesting that ''a preferred stock investment with the liquidating dividend payable to the extent of available assets'' should be considered an Equity Capital Investment. SBA's interpretation of the Small Business Investment Act of 1958, as amended (''Act'') is that dividends may be payable only to the extent of retained earnings; this treatment is consistent with the statutory language concerning subordinated debt instruments, which can qualify as Equity Capital Investments if, among other things, they ''provide for interest payments contingent upon and limited to the extent of earnings.'' Accordingly, the definition is finalized without change.

f. ''Institutional Investor''

In the proposed rule, SBA added language to the definition of ''Institutional Investor'' to clarify that an entity cannot satisfy the net worth test on the basis of unfunded commitments from its investors. One commenter suggested that this language be dropped and that such commitments be recognized. SBA disagrees with this suggestion because it increases the government's financial risk. SBA has protections in place which allow it to require Institutional Investors to fund their commitments to a Licensee under certain circumstances; however, it is unlikely that such requirements could be extended to investors who are one or more levels removed from the Licensee. Therefore, the proposed definition is adopted as final.

g. ''Start-Up Financing''

The proposed rule did not make any changes in this definition, but used it in a new context—it was proposed that Licensees be permitted to take temporary Control of Start-Up Financing under § 107.865(d). In this context,

several commenters felt that the definition was too narrow in terms of the types of businesses covered, the length of time the business had been in existence, and the exclusion of businesses formed to acquire existing businesses. SBA agrees that a broader definition is appropriate for purposes of § 107.865 and is not objectionable for purposes of determining Capital Impairment, the other context in which it appears. Accordingly, the final rule largely eliminates these restrictions. A business formed as an acquisition company can qualify as long as the acquired company meets the criteria for a Start-Up Financing.

The limitations on sales revenue and cash flow have also been modified: Under paragraph (3) of the proposed definition, companies could not have ''sales exceeding $5,000,000 or positive cash flow in any fiscal year.'' The final rule prohibits ''sales exceeding $3,000,000 or positive cash flow from operations in any of the past three fiscal years.'' SBA believes the lower sales ceiling is more appropriate to a true start-up company; the other changes respond to comments received.

h. ''Unrealized Appreciation''

The proposed definition is adopted with one minor editorial change.

i. ''Unrealized Depreciation''

The proposed definition is adopted with one minor editorial change.

j. ''Qualified Non-Private Funds''

The proposed definition, which appears in § 107.230(d), is adopted without change. SBA received one comment objecting to the language that permits government grants to nonprofit entities to be Qualified Non-Private Funds ''if SBA determines that such funds have taken on a private character and the nonprofit corporation or institution is not a mere conduit.'' SBA believes the language is an appropriate interpretation of the Act; in particular, the ''private character'' standard is specifically cited in the legislative history.

3. Subpart C—Qualifying for an SBIC License

a. Organizing a Licensee

Comments received on proposed § 107.100 and § 107.110 questioned why Section 301(c) and Section 301(d) Licensees could not be formed as limited liability companies. Limited liability companies are not a permitted form of organization recognized by the Act. Therefore, the rule is adopted as proposed.

b. 1940 Act and 1980 Act Companies

SBA received several comments on proposed § 107.115, all of which objected to the restriction against licensing 1940 Act or 1980 Act companies that elect to be taxed as regulated investment companies under section 851 of the Internal Revenue Code. SBA is persuaded that Licensees would not be denied the ability to access capital by using these structures. Therefore, the final rule allows Licensees to organize as or convert to 1940 Act or 1980 Act Companies, and to elect to be taxed as regulated investment companies. The regulation also clarifies that when the tax code conflicts with SBA regulations or guidelines governing distributions, the SBA requirements will apply unless the Licensee requests and receives a waiver in accordance with the regulations.

c. SBA Approval of Initial Management Expenses

Proposed § 107.140, which requires all new SBIC license applicants (not just applicants planning to issue Participating Securities) to obtain SBA approval of their initial Management Expenses, is adopted with one change: This section will not apply to non-leveraged Licensees, which present no financial risk to the Agency.

d. Management and Ownership Diversity

Proposed § 107.150, which requires all license applicants planning to obtain Leverage to have diversity between management and ownership, is adopted without change. SBA received one comment that applicants should be permitted in all cases to satisfy the diversity requirement on a ''look through basis'' (that is, at the parent level). This option is available to Licensees if SBA approves; however, as stated in the preamble to the proposed rule, the Agency believes it must have discretion in this area in order to assure that a Licensee has genuine diversity, as opposed to an ownership structure that provides ''technical'' diversity but does not satisfy the intent of the regulation.

e. Special Rules for Partnership Licensees

Proposed § 107.160(b), allowing an Entity General Partner to be organized for the sole purpose of serving as the general partner of one or more licensees, is adopted without change. SBA considered the comment suggesting that an Entity General Partner not be precluded from other activities, but rejected the suggestion due to the complexity of examining a general partner involved in both SBA and non-SBA related activities. The Agency believes that this would result in an undue burden both on its examiners and on the Entity General Partner.

f. Minimum Capital Requirements for Licensees

SBA received one comment on proposed § 107.210(b) (which did not contain any substantive changes) suggesting that the Regulatory Capital requirement for Section 301(d) Licensees be inclusive, not exclusive of, unfunded commitments. This comment is inconsistent with SBA's interpretation of the minimum capital requirements of the Act; therefore, the proposed rule has been adopted as final without change.

g. Special Minimum Capital Requirements for Licensees Issuing Leverage

A comment received on proposed § 107.220(b) argued in favor of omitting the ''special'' minimum capital requirements which require any company licensed after the regulation is finalized to have Regulatory Capital of at least $5,000,000 in order to apply for Debentures, unless it demonstrates to SBA's satisfaction that it can be financially viable over the long term with a lower amount. The same commenter also suggested revising the ''grandfather'' provisions in § 107220(c)(1), which allow certain existing Licensees that do not meet the current minimum capital requirements to receive additional Leverage if they are profitable. The commenter wrote that other criteria besides profitability should be considered.

SBA is finalizing both provisions as proposed. The Agency considers these standards to be vital to the continuing success of the SBIC program. As stated in the preamble to the proposed rule, a review of the financial performance of Licensees supports the conclusion that higher levels of Regulatory Capital significantly reduces the likelihood of unprofitable operations over the long term. As to § 107.220(c), the profitability criterion has been used since 1990, and SBA continues to believe that profitability is the best and most objective indicator of future successful operations.

SBA has made two editorial changes to proposed § 107.220(c)(2). Proposed paragraph (c)(2)(i), which deals with Debentures maturing before December 31, 1995, has been deleted because it is not longer applicable. Proposed paragraph (c)(2)(ii) has been incorporated into paragraph (c)(2) and revised by replacing ''a term of three years'' with ''a term to be determined by

SBA.'' This change has been made because three-year Leverage is not routinely available at this time.

h. Limitations on Accepting Non-Cash Capital Contributions

The heading of proposed § 107.240 has been revised to read ''Limitations on including non-cash capital contributions in Private Capital'', which is more consistent with the substance of the section. One commenter suggested that the section be revised to state that Licensees may still accept non-cash assets that cannot be included in Private Capital. SBA did not adopt this suggestion, primarily because of its concerns about liabilities that may be associated with unapproved non-cash assets. Therefore, except for the change in the section heading, proposed § 107.240 is finalized without change.

i. Issuance of Stock Options by Licensees

SBA agrees with the comment that proposed § 107.250(a), which states that a Licensee may issue stock options, is unnecessary and has deleted it in the final rule. The deletion does not affect a Licensee's ability to issue stock options.

j. License Application Form & Fee

A comment received on proposed § 107.300 objected to the increase in the license fee for partnerships that plan to issue participating securities, particularly those using the standard partnership agreement annex already approved by SBA. SBA proposed the fee increase in order to reflect the Agency's costs of processing applications. Pursuant to applicable statutory provisions, the Administration has taken into consideration direct and indirect costs to SBA of necessary services performed, value to the recipients, the public policy interest served and other pertinent factors involved. After due consideration, SBA believes the increase in fees to be justified and is finalizing § 107.300 as proposed.

4. Subpart D—Changes in Ownership, Control, or Structure of Licensee; Transfer of License

a. Changes in Control/SBA Prior Approval

Section 107.410 requires SBA's prior approval for a change of Control while § 107.440 sets out the standards governing SBA's approval. One commenter suggested that a grandfather clause be adopted for these sections. The effect of such a clause would be to allow an existing Licensee to undergo a change of Control without having to meet the increased minimum capital requirements currently in effect. SBA believes that a grandfather clause is not necessary because the Agency will apply the capital adequacy and financial viability standards of §§ 107.200 and 107.220 in evaluating an application for a change of Control. Therefore, both sections are finalized without change.

b. Restrictions on Common Control or Ownership of Two (or More) Licensees

SBA agrees with the comment that § 107.460, which requires SBA approval of common Control or ownership of two or more Licensees, should not be applicable to unleveraged Licensees, so long as none of the Licensees involved has any Leverage. This change has been incorporated in the final rule.

5. Subpart E—Managing the Operations of a Licensee

a. Identification as a Licensee

SBA received one comment which argued the difficulty of identifying an SBIC as a Federal Licensee on each Financing document. SBA agrees, and has decided to revise proposed § 107.501 to state that before extending Financing or collecting an application fee from a Small Business, a Licensee must obtain a written statement from the concern acknowledging its awareness that it is dealing with a Federally licensed SBIC.

b. Licensee's Adoption of an Approved Valuation Policy

Many comments on proposed § 107.503(c) objected to the language which sated that ''SBA reserves the right to review or independently establish valuations of your Loans and Investments''. All the commenters agreed that SBA should only become involved in a specific valuation if that valuation is in violation of the agreed upon valuation policy. The proposed language was intended to address SBA's continuing concerns regarding certain instances of egregious non-compliance with agreed-upon valuation policies, and the difficulties it has encountered in its attempts to take action regarding such non-compliance. However, in recognition of the legitimate concerns of Licensees, SBA is revising § 107.503. In the final rule, the language cited at the beginning of this paragraph has been replaced by the following: ''If SBA reasonably believes that your valuations, individually or in the aggregate, are materially misstated, it reserves the right to require you to engage, at your expense, an independent third party, acceptable to SBA, to substantiate the valuations.''

In addition, purposed § 107.503(d)(4) has been revised by adding the word ''adverse'' before the word ''change'', so that only material adverse changes in valuations must be reported quarterly to SBA.

c. SBA Approval of Licensee's Investment Adviser/Manager

SBA agrees with the comment on proposed § 107.510 that annual approval of the management contract by the Licensee's board of directors is unnecessary. The proposed rule has been revised and is finalized accordingly.

d. Restrictions on Investments of Idle Funds by Leveraged Licensees

With one change, proposed § 107.530 regarding idle funds is adopted as proposed. The section has been amended to permit Licensees to maintain a reasonable petty cash fund.

e. Limitations on Secured Third-Party Debt

As discussed in the preamble to the proposed rule, proposed § 107.550(a) was intended primarily as a restatement of the existing regulation requiring leveraged Licensees to obtain SBA approval before incurring secured third-party debt. The only change was the requirement that Licensees also obtain SBA approval before expanding the scope of a security interest or lien associated with existing debt. Based on some of the comments received, SBA realized that paragraph (a) was being misinterpreted. In particular, it was not SBA's intention to require approval each time a Licensee wants to draw down an approved line of credit. Nor did SBA intend to require Licensees to obtain approval to substitute one asset or group of assets for another as the subject of a security interest, as long as the values are comparable. In the final rule, proposed § 107.550(a) has been split into two paragraphs and revised to clarify the intent.

Two comments were received on proposed § 107.550(c), suggesting that the limitation of the security interest to 125 percent of a proposed borrowing against a Licensee's investor commitments is impractical. SBA recognizes that some Licensees may not be able to borrow under this provision. However, it is only with reluctance that the Agency has permitted *any* third-party borrowing against investor commitments, since these are the same commitments that SBA may look to at some point to protect its own financial interests. Therefore, SBA is finalizing this provision (renumbered as § 107.550(d)) without change.

Proposed § 107.550(d) stated the conditions under which SBA will provide a 30-day turnaround on applications for approval of secured third-party debt. One of these conditions was that the security interest be limited to the assets acquired with the borrowed funds, or an asset coverage ratio of no more than 1.25:1. SBA agrees with the commenters who suggested that the coverage ratio is unrealistically low, and is revising the ratio to 2:1 in the final rule (with this paragraph renumbered as § 107.550(e)).

f. Subordination of SBA's Creditor Position

Proposed § 107.560 is adopted without change. One commenter argued that without a specific definition of subordination, expressed in a formal subordination agreement, Licensees would find it impossible to obtain third-party debt. SBA's experience with the subordination regulation, which was first adopted in 1991, is that lenders have been willing to work out the details of subordination agreements with SBA on an individual basis. Nevertheless, SBA is sympathetic to Licensees' desire to understand the Agency's specific concerns in this area, and will attempt to develop guidelines for a subordination agreement that would be generally acceptable to SBA.

g. Activity Requirement

SBA received several comments on proposed § 107.590 suggesting that the activity test is unnecessary, or should be revised, or should not apply to non-leveraged Licensees.

SBA strongly believes that some form of activity test is necessary for both leveraged and non-leveraged Licensees. Companies are licensed with the understanding that they will help to fulfill the public purpose of the program, which is to further the growth and development of small businesses. Clearly, an inactive Licensee is not contributing to this goal. Furthermore, an inactive Licensee, even if it is non-leveraged, imposes some degree of administrative burden on SBA.

In response to the comments concerning the specific structure of the activity requirements, SBA has made a number of changes intended to make the test more practical and to modify provisions that were subject to interpretation. In the proposed rule, the basic activity test (in § 107.590(a)) required a Licensee to satisfy two criteria dealing with investment activity and percentage of assets maintained as idle funds. In the final rule, a Licensee must satisfy only one of the criteria to be considered active.

In paragraph (b)(1), the proposed rule stated that certain ''recent'' cash inflows would be disregarded in determining whether a Licensee is active. In the final rule, ''recent'' has been replaced by a specific time period (within nine months of the Licensee's fiscal year end).

In paragraph (b)(3), under the proposed rule, one of the criteria for an exception to the activity requirements was that a Licensee have ''no remaining unfunded commitments from investors''. SBA agrees with the commenter who suggested that this standard was too narrow, and has revised the provision to include Licensees with unfunded commitments equal to no more than 20 percent of their Regulatory Capital.

Finally, in § 107.590(d), SBA has added a phase-in period for new Licensees, recognizing that the activity test is not relevant to those companies that have been in operation for less than 18 months.

6. Subpart F—Recordkeeping, Reporting, and Examination Requirements for Licensees

a. Information Required From Portfolio Concerns

With some minor changes, § 107.620 is adopted as proposed. SBA is not adopting the suggestion of one commenter that paragraphs (a) and (b), which require Licensees to obtain certain information from Small Businesses before extending Financing and on a periodic basis thereafter, should not apply to non-leveraged Licensees. Although one of the aims of these paragraphs is to mitigate SBA's financial risk, they are also intended to insure that Licensees are operating in a manner consistent with the goals of the Act. SBA agrees with the comment that paragraph (b)(2), which requires that the information submitted to the Licensee be certified by the chief financial officer, general partner, or proprietor of the Portfolio Concern, should be expanded to permit certification by the chief executive officer, President, or Treasurer. The section is finalized accordingly.

b. Requirements for Licensees To File Annual Financial Statements

Except as hereafter noted, SBA adopts as final proposed § 107.630, which deals with the requirements for filing annual financial statements with SBA. Based on comments received, SBA has added language to § 107.630(a) clarifying that the portion of SBA Form 468 containing economic information on the Licensee's portfolio companies may be filed up to two months later than the remainder of the form; this reflects SBA's current policy. In § 107.630(b), a cross reference to § 107.1220 has been added to clarify the reporting requirements for Licensees with outstanding Leverage commitments.

One commenter suggested that the ''economic impact'' information required by proposed § 107.630(e) places an unfair burden on the Licensee. SBA is finalizing this paragraph as proposed; the information requirement is not new, having been in effect since April 25, 1994, and § 107.630(e) is actually worded more narrowly than the current regulation that it replaces. While SBA considers the economic impact information to be vitally important to the mission and future of the SBIC program, the Agency recognizes that this information is not always easy to obtain. SBA has generally accepted Licensees' good faith efforts to provide the required data and will continue to do so to the extent possible.

Proposed § 107.630(a)(2) would have required a Licensee's independent public accountant to carry errors and omissions insurance in an amount acceptable to SBA, or be self-insured and have net worth acceptable to SBA. This proposal elicited comment from representatives of the accounting profession who objected to SBA's attempt to create a ''deep pocket'' for recovery of damages, as well as concern from a few other commenters that the amount of insurance required be more clearly defined. SBA is sensitive to concerns that this requirement may prevent many smaller, but highly competent, practitioners from performing SBIC audits; however, the Agency also must consider its need to control financial risk. Furthermore, SBA feels that the ability of a firm to obtain some amount of insurance can be, in itself, a useful indicator of professional standing. After careful consideration of the issue, SBA is finalizing § 107.630(a)(2) to require the independent public accountant to have errors and omissions insurance of at least $1,000,000, or to be self-insured and have a net worth of at least $1,000,000, unless SBA approves otherwise. This wording will give SBA the flexibility to make exceptions for firms that do not meet the insurance requirement but have strong track records as auditors of SBICs or similar entities.

c. Changes Not Subject to SBA Prior Approval

Proposed § 107.680 has been finalized with one change. A commenter suggested that this section, which

requires SBA's post approval of certain changes in the Licensee's operations, capitalization, and management, should not apply to non-leveraged Licensees. SBA does not entirely agree, particularly with regard to changes that cause Licensee to operate in a different way than was contemplated at the time it was licensed. However, for Licensees that have no outstanding Leverage or Earmarked Assets, SBA believes safety and soundness considerations do not require post approval of directors and officers (other than the Licensee's chief operating officer), and that it is sufficient for such Licensees to notify SBA of any changes.

d. Responsibilities of Licensee During Examination

Proposed § 107.691 included a provision requiring a Licensee and its independent public accountant to agree that the accountant's working papers would be made available to SBA upon request for examination purposes. One commenter stated that this requirement would not be objectionable if SBA provided assurance that any workpapers requested would be treated as confidential under the Freedom of Information Act (FOIA) or similar laws. An accountant's working papers relating to an individual Licensee are indeed protected from disclosure under the exemptions available under FOIA. Since these exemptions are statutory, SBA believes it is unnecessary to restate them in the regulations, and § 107.691 is finalized as proposed.

e. Examination Fees

SBA received more than ten comments on proposed § 107.692. All of the comments objected to the increase in the examination fees to be charged to SBICs. Many stated that the cost of an SBA examination would far exceed the cost of their annual audit, even though the procedures involved are more limited. Further, some felt that unleveraged licensees would bear an unfair portion of the overall fees due to the fact that the fees are to be assessed on total assets of the Licensee. Unleveraged (usually bank owned) SBICs tend to have the largest amount of total assets yet have no federal funds at risk. Therefore, it was argued that the cost of enforcement should weigh more heavily against leveraged Licensees.

As stated in the preamble to the proposed rule, the proposed fee schedule was designed to produce total revenue sufficient to cover the current direct costs to SBA of conducting examinations. SBA considers examinations to be a key element in maintaining the integrity of the SBIC program. However, based on the comments, SBA is persuaded that the proposed fees were too high in general, and that the increases were particularly excessive for the largest Licensees. In the final rule, the examination fees have been lowered significantly, although they still represent an increase over the current levels.

7. Subpart G—Financing of Small Business by Licensees

a. Ineligible Small Businesses

Under proposed § 107.720 (a) through (i), SBA lists those Small Businesses which are ineligible for SBIC Financing and certain exceptions to those restrictions. Except for the revisions discussed below, this section is finalized as proposed.

SBA received seventeen comments on this proposal. One comment questioned whether § 107.720 as a whole should be applicable to non-leveraged Licensees. Another suggested deletion of the prohibition in § 107.720(a) against financing relenders or reinvestors as this type of financing could result in jobs and the payment of taxes. Neither of these comments were adopted because the provisions in question are mandated by the Act.

b. Passive Businesses

One of the criteria defining a passive business in proposed § 107.720(b) is that the business ''is not engaged in a regular and continuous business operation''. The proposed rule goes on to state that the ''mere receipt of payments * * * such as * * * lease payments'' would not be considered a regular and continuous business operation. One commenter asked how this definition would apply with respect to taxi medallion financing, an industry in which several SBICs already have millions of dollars invested. It is common practice in this industry for medallion owners to lease their medallions rather than employ taxi drivers directly.

SBA's previously-stated position regarding taxi medallion lending is that Licensees may finance medallion owners who lease the medallions to others, but only if such owners are actively engaged in day to day management activities. These include supervision of lessees and responsibility for vehicle maintenance, insurance, and compliance with local laws and regulations. Owners who lease their medallions and receive payments without such active involvement will continue to be considered passive businesses under the final rule.

Two comments objected to proposed § 107.720(b)(1)(ii), which would define as passive any companies whose employees are not carrying on the majority of the day to day operations. The commenters argued that many businesses use third parties, including independent contractors and ''leased'' employees, to carry on day to day operations. SBA recognizes that such arrangements are now common and are not necessarily an indicator of a passive business. The final rule has been revised to define a business as passive if ''its employees are not carrying on the majority of day to day operation, and the company does not provide effective control and supervision, on a day to day basis, over persons employed under contract''.

Proposed § 107.720(b)(2) was a restatement of the existing ''holding company'' exception to the passive business rule, under which Licensees could finance a passive business if it passed through all the proceeds to a wholly-owned active business. A number of comments suggested that the provision could allow something less than 100 percent of the proceeds to be passed through without compromising the intent of the regulations. SBA agrees and has changed the final rule to require pass-through of ''substantially all'' the proceeds. The commenters also suggested deletion of the requirement that the active business be wholly-owned. SBA agrees that this restriction is not necessary. Instead, the final rule allows the financing of a passive business ''if, for all Financings extended, it passes substantially all the proceeds through the *same* eligible Small Business that is not passive'' (italic are added). This revision clarifies that a holding company must pass the Financing proceeds to only one Small Business, not to multiple businesses or to a series of different businesses if Financing is extended on more than one occasion.

c. Real Estate Businesses

SBA agrees with a comment which suggested that proposed § 107.720(c)(2) is too restrictive, in that it prohibits financing the acquisition of unimproved realty if the business does not intend to build on the property, even if the business intends to use it for another legitimate business purpose such as a parking lot for customers and employees, SBA did not intend to prohibit financing for this purpose and the final rule has been revised accordingly.

d. Project Financing

One comment objected to the prohibition against project financing in proposed § 107.720(d). As stated in the preamble to the proposed rule, though this prohibition does not appear in the current regulations, it has been in effect as a matter of policy for more than ten years. SBA views project financing as essentially short term and therefore, inconsistent with the Act. SBA considers this prohibition important and is therefore finalizing the rule without change.

e. Foreign Investments

With one change, proposed § 107.720(g) is adopted as final. The proposed rule generally would have prohibited financing a Small Business if more that 40 percent of its employees or tangible assets were located outside the United States. In response to comments suggesting that this percentage was too low, SBA has increased the allowable percentage to 49 percent in the final rule.

f. Conflicts of Interest

SBA received seven comments on proposed § 107.730. The proposed rule is adopted with changes to meet some of the concerns in the comment letters. One comment suggesting that the conflict of interest prohibitions not be applicable to unleveraged Licensees was rejected by SBA. Such an exception would be inconsistent with the purpose of the Act.

Two commenters were concerned that proposed § 107.730(a)(2), which deals with providing Financing to an Associate of another Licensee, would unduly restrict co-investing. In particular, the concern was whether the regulation could be construed to mean that if a Licensee brought an investor group involving another Licensee and its Associates into one of its investments, it would be prohibited from any future participation in investments initiated by that investor group. This interpretation is contrary to SBA's intent, which was to prohibit quid pro quo financing arrangements that would allow Licensees to accomplish indirectly what they are not permitted to do directly—provide Financing to an Associate. SBA does not consider it necessary to revise paragraph (a)(2) to clarify the intent, since the language is essentially unchanged from the previous regulations.

Proposed § 107.730(d) set forth provisions governing investments in the same Small Business by a Licensee and its Associates, either simultaneously or at different times. In general, Licensees were required to demonstrate that the terms and conditions of such investments were fair and equitable to the Licensee. The proposed rule identified certain categories of Financing with Associates requiring SBA approval, and others that would be exempt from this requirement. Two comments suggested that the exemption in paragraph (d)(3)(iv) should be expended to include all situations where the Licensee is nonleveraged, regardless of the status of the Associate. SBA believes the exceptions provided are adequate and is not adopting this suggestion.

Proposed § 107.730(e)(1) would require a Licensee to obtain SBA's written approval for an Associate to participate in the management of a Portfolio Concern if the Associate has an actual or potential equity interest in the Portfolio Concern that exceeds 3 percent. Comments received suggested that 5 percent is a more generally accepted standard used by other federal regulatory agencies in similar circumstances. SBA agrees and is revising the final rule accordingly.

One comment was received urging the elimination of the publication requirement of proposed § 107.730(g), which requires SBA to publish notice of exemptions requested under § 107.730. The concern was that this requirement could slow down Financings, work a hardship on the Small Business or potentially disclose confidential information to competitors. Although SBA is sympathetic to these concerns, the publication requirement is mandated by the Act and cannot be deleted.

g. Overline Limitation

Three comments were received on proposed § 107.740. One commenter suggested that the ''overline'' limits not be imposed on non-leveraged Licensees. This exemption has been effective since April 1994 and was included in the proposed rule. The other comments dealt with paragraph (c), which allows Licenses to compute an ''increased limit'' if they have unrealized gains on Publicly Traded and Marketable securities. Both commenters advocated a more liberal cure period if a Licensee has overline violations resulting from a drop in the value of its securities. Because of the inherent volatility of publicly traded securities, SBA does not consider it prudent to encourage the use of the increased limit and is finalizing the proposed rule without change.

h. Change of Ownership

The comments received on proposed § 107.750 addressed the definitions of ''debt'' (paragraph (c)(2)) and ''equity'' (paragraph (c)(3)) used in determining whether the Small Business has an acceptable debt to equity ratio. It was suggested that the definition of ''debt'' (which, in this section, generally means long-term debt) specifically exclude any liabilities under a non-compete covenant with the seller. SBA chose not to add this automatic exclusion because such covenants are unique to the circumstances of each transaction. It was also suggested that the definition of ''equity'' should include subordinated notes payable to the seller. Such notes are specifically excluded from the definition of debt; to also include them in equity would further reduce the debt to equity ratio. SBA believes this result is inconsistent with the intent of the regulation and is finalizing the section as proposed.

i. Change in Size or Activity of a Portfolio Concern—Affect on Licensee

SBA did not propose any change in the provisions governing additional investment in a Portfolio Concern that no longer meets the size standard. However, one commenter suggested that proposed § 107.760(a) should be revised to allow a Licensee to make additional investments in such a concern either to honor a Commitment it has made or to protect its investment. The proposed rule already allows a Licensee to make follow-on investments without restriction in any Portfolio Concern up to the time it makes a public offering, so the commenter's suggestion would be relevant only after that time. SBA has added language to the final rule permitting a Licensee to honor a Commitment made before a public offering, since it would be legally bound to do so in any case. However, the Agency believes the ''protection of investment'' standard is so broad as to be inconsistent with the goals of the program and has not adopted this change.

In response to a comment, proposed § 107.760(b) is being adopted as final with one non-substantive change. Paragraphs (b)(2) and (b)(3), which state that violations under paragraph (b) constitute default by the Small Business and allow the Licensee to pursue certain remedies, have been deleted. SBA agrees that these provisions cover matters that should be left to the Licensee and that it is unnecessary to include them in the regulations.

j. Definition of ''Equity Securities''

SBA received two comments on the definition of Equity Securities in proposed § 107.800. One suggested that the definition should include warrants

and options. SBA agrees and has revised the section accordingly. The other commenter sought clarification of the statement that the presence of certain default or redemption provisions would cause a security, even if it has the legal form of equity, to be considered a Debt Security ''for all regulatory purposes''. SBA's intent was that such a security would be treated as a Debt Security only for purposes of § 107.855, the Cost of Money regulations. The final rule is revised accordingly.

k. Options Received From Small Businesses

Except for the following changes and revisions, proposed § 107.815(b) is adopted as final. This section restricts the ability of a Licensee's employees, officers, directors, or general partners to receive options in a Small Business Financed by the Licensee. Under the proposed rule, such persons could receive options only if they participated in the Financing on the same terms and conditions as the Licensee (paragraph (b) (1)) or if approved by SBA (paragraph (b) (2)).

Three comments were received on this section. Two suggested that paragraph (b) not be applicable to non-leverage SBICs and SBA agrees. The provision is revised accordingly.

Two commenters suggested that the regulations should permit the receipt of stock options as compensation of service as a board member, as this is a common practice in the industry and is beneficial to the Small Business. SBA agrees and has added § 107.815(b)(3) to the final rule to permit this practice, with the condition that the compensation paid must not exceed that paid to other outside board members. In the absence of such board members, fees must be reasonable when compared with amounts paid to outside directors of similar companies.

l. Guarantees of the Obligations of Small Businesses

SBA received one comment seeking to clarify that if a Licensee invests in a Small Business and also guarantees its debt obligation, the guaranty should count against the overline limitation only to the extent of the Licensee's risk over and above its original investment. The situation described by the commenter is covered by § 107.820(a)(2), which states that a guaranty consisting only of ''a pledge of the Equity Securities of the issuer'' does not count towards the overline limitation.

m. Commitments to Small Businesses

SBA received one comment suggesting that proposed § 107.825 be deleted, a second suggesting that it be moved back to the definitions section, and a third seeking clarification as to whether ''reasonable conditions precedent'' to a Licensee's obligation to fund its commitment can include ''completion of due diligence which confirms the accuracy of the initial business plan''.

SBA is not deleting the defined term ''Commitment'' from the regulations because it is used in several important contexts (see, for example, the new provision in § 107.860(g) that allows a Licensee to charge a ''breakup fee'' if a Small Business accepts its Commitment and then fails to close because it has accepted funds from another source). SBA agrees that proposed § 107.825 properly belongs in the definitions section and has revised the final rule accordingly.

SBA has addressed the meaning of ''reasonable conditions precedent'' in an earlier preamble and will repeat that discussion here: Although SBA is reluctant to provide a list of reasonable conditions precedent in the regulation for fear that such list might be regarded as an exclusive one, it is willing to describe ''reasonable conditions precedent'' in general terms. A ''reasonable condition precedent'' is one that does not lie within the Licensee's ability to cause or prevent. ''Completion of due diligence with results satisfactory to the Licensee'' is an example of a condition precedent that lies within the Licensee's control. On the other hand, requirements that a disinterested person verify the value of the Small Businesses' assets or its net worth, or that there be no adverse change in the Small Businesses' financial condition between the date of the commitment and the scheduled disbursement date, or that the Small Business do or achieve something that lies reasonably within its capacity would all be considered a ''reasonable condition precedent.''

n. Purchasing Securites From an Underwriter

Comments received on proposed § 107.828 requested relief for non-leveraged Licensees, reduction or elimination of recordkeeping requirements and reconsideration of fee limitations for Associate underwriters. SBA believes certain constraints on purchasing securities from underwriters are warranted in keeping with the purpose of the Act, but has made some revisions in response to the comments. Non-leveraged Licensees have been exempted from the recordkeeping requirements in paragraph (b) and the fee restrictions in paragraph (c). For leveraged Licensees, paragraph (c) has been revised to permit a Licensee to pay ''reasonable and customary'' commissions and expenses to an Associate underwriter, provided the Licensee is purchasing no more than 25 percent of the total offering.

In the final rule, this section is renumbered as § 107.825.

o. Minimum Term of Financing

The comments received on proposed § 107.830 strongly supported the changes made with regard to the minimum term of Financings for Section 301(d) Licensees. One commenter suggested allowing Section 301(c) Licensees to have up to 25 percent of their investments with less than a five year term as long the weighted average duration of the portfolio is at least five years. SBA believes such a provision is not in keeping with the intent of the Act and would impose a burdensome recordkeeping requirement. Accordingly, SBA is finalizing the proposed rule without change.

p. Exceptions to Minimum Term of Financing

One commenter requested a clarification of proposed § 107.835, which allows a Licensee to make Short-term Financings (with terms less than five years) under certain circumstances. The commenter asked whether the provision in paragraph (c), which limits the dollar amount of Short-Term Financings to 20 percent of total Loans and Investment applies only to that paragraph or to all of § 107.835, as has been the case in the past. It was SBA's intent to apply the 20 percent limit only to paragraph (c), which deals with Short-Term Financing for the purpose of financing a change in ownership under proposed § 107.750. Therefore, the section is finalized as proposed. However, as stated in the preamble to the proposed rule, Licensees should bear in mind that the purpose of the SBIC program, as stated in the Act, is to provide equity capital and long-term loan funds to Small Businesses. Thus, Licensees should not plan to have the bulk of their portfolios in short-term investments; to do so would constitute engaging in activities not contemplated by the Act.

q. Maximum Term of Financing

All of the comments received on proposed § 107.840 suggested that the general rule which requires a maximum term of not longer than 20 years for any

Financing should apply only to Loans and Debt Securities. SBA agrees and has revised the final rule accordingly.

r. Redemption of Equity Securities

Two comments were received on proposed § 107.850. One commenter suggested that book value should be a permitted basis for determining the redemption price of an Equity Security under § 107.850(b)(2)(ii). SBA agrees and has revised the final rule accordingly.

The other commenter stated that § 107.850(b)(1) should be broadened to allow accumulated dividends to be included in the redemption price of an Equity Security. SBA is not adopting this change. A Licensee is already permitted to structure its investments in this manner; the only consequence is that such investments are subject to the Cost of Money rules. Furthermore, as long as the dividends are payable only from earnings, such investments are not precluded from qualifying as Equity Capital Investments.

s. Cost of Money

Under proposed § 107.855, SBA sought to substantively revise some of the Cost of Money rules and to clarify others. SBA received six comments on this section, two of which advocated deleting the entire section and letting the market control. While the proposed rule gave Licensees considerable more flexibility than in the past, the Agency believes that some Cost of Money rules are necessary to provide a measure of protection for Small Businesses. The commenters generally applauded the increase in the minimum ''Cost of Money ceiling'' for Loans in § 107.855(c); however, some argued that the ceiling for Debt Securities should also be raised. SBA believes that the proposed five percentage point difference between Loans and Debt Securities is justified because Loans do not allow for the Licensee to obtain any equity interest in the Small Business, and is finalizing this provision without change.

One comment stated that it was very important for Licensees to be able to establish the Cost of Money ceiling for a Financing as of the date a Commitment is issued, not as of the date of the first closing as proposed in § 107.855(b). The commenter explained that if rates went up between a Commitment date and a closing date, they would be able to increase the rate quoted in the Commitment. However, if rates went down, they would be forced by regulations to close at the lower rate. SBA is persuaded that Licensees should have flexibility in this area and has revised this paragraph to allow the ceiling to be set either at the time the Commitment is issued or as of the date of the first closing of the Financing.

A Licensee is permitted to compute its Cost of Money ceiling based on either the current Debenture rate on its own ''Cost of Capital'' as determined under proposed § 107.855(d). SBA received one comment suggesting that non-leveraged Licensees should be permitted to compute a Cost of Capital based on their non-SBA borrowings. The proposed rule would permit this practice and is therefore finalized without change.

Proposed § 107.855(g)(10) would allow a Licensee to charge a higher interest rate when a Small Business is in default. For this purpose, ''default'' is defined to include failure to provide information required under SBA regulations. One commenter pointed out that this appears to require Small Businesses to have knowledge of SBA regulations, and that it is the responsibility of Licensees to put all necessary default provisions in the Financing documents. SBA agrees and has deleted the reference to SBA regulations from the final rule.

Proposed § 107.855(i)(3) would allow Licensees to charge a one-time ''bonus'' at the end of a loan instead of taking equity in the Small Business. One commenter suggested that the bonus not be limited to one time only, and that the bonus be computable on the earlier of five years or when the debt was originally due.

SBA proposed the bonus to allow Licensees to obtain an adequate return on Financings of companies that do not want to give up equity. The Agency believes the proposed rule provides Licensees with sufficient flexibility and is not adopting the suggested changes. However, SBA is clarifying § 107.855(i)(1) in the final rule to state that the bonus is computable ''on or after the date that the Financing is repaid in full or was originally scheduled to be repaid in full, whichever is earlier''.

SBA has also made an editorial change in § 107.855(i)(3), which states that a bonus must be contingent upon factors that reflect the performance of the Small Business. As an example, the proposed rule stated that net income and operating cash flow were generally acceptable factors, while gross revenue and gross profit were generally unacceptable. One commenter interpreted ''gross profit'' as pretax profit and suggested that this should be acceptable. SBA's interpretation of ''gross profit'' was the difference between sales and cost of goods sold, also known as ''gross margin''; to avoid confusion, the latter term is used in the final rule.

s. Financing Fees Charged to Small Businesses

Two comments received on proposed § 107.860 dealt with problems faced by Licensees in their dealings with Small Businesses that apply for Financing. According to the comments received, it is not unusual for a Small Business to use a Licensee's Commitment to solicit competing offers. Also, there are a number of frivolous ''shoppers'' who will use a Licensee's time and resources with no genuine intent of closing a transaction. One such commenter suggested that Licensees be permitted to address these problems by charging a ''break-up'' fee if a Small Business fails to close a Financing because it has accepted funds from another source. SBA is persuaded that the break-up fee represents a reasonable protection for Licensees and has finalized § 107.860 with a new paragraph (g) containing this provision. The permitted fee is the same as the closing fee the Licensee would have been permitted to charge under § 107.860 (c) or (d).

Another comment questioned whether the ''application fee'' and the ''closing fee'' had to be two distinct fees separately identified, or whether they could both be collected together at closing. To clarify SBA's intent, language has been added to paragraph (a) of the final rule stating that the application fee may be collected at closing or at any time before closing.

t. Control of a Small Business

Twelve comments were received on proposed § 107.865. One comment objected to paragraph (b) which establishes a ''presumption of Control'' based on a Licensee's percentage of ownership, stating that this paragraph represented a ''poor and onerous change'', and further noting that investor groups typically own 75 percent of a business by the second or third round of Financing. In response, SBA, wishes to point out that the proposed provisions concerning the presumption of Control are exactly the same as those in the previous regulations. However, proposed paragraph (c) was added to identify specific conditions that would permit the presumption of Control to be rebutted. By defining such conditions, the provision was actually intended to make it easier for a Licensee to co-invest.

With respect to proposed § 107.865(c), two commenters argued that the ''presumption of Control'' should be

rebutted if management can elect 25 percent of the board seats. SBA believes 40 percent is an appropriate standard for an automatic rebuttal; Licensee can still seek to rebut the presumption based on other evidence if this test is not met. Accordingly, proposed paragraphs (b) and (c) are finalized without change.

u. Temporary Control

Proposed § 107.865(d) set out those circumstances under which a Licensee may take temporary Control of a Small Business, and includes the provision: ''(1) Where reasonably necessary for the protection of your investment under circumstances where a Small Business is threatened with insolvency or closure.'' Several commenters suggested that by the time insolvency or closure occurs, it is often too late to ''protect their investment''. SBA agrees and has revised the final rule to delete all of the language after the word ''investment'' in § 107.865(d)(1). However, SBA advises Licensees that mere disagreement with the management of a Small Business does not provide grounds for taking temporary Control under this provision; rather, the Licensee must be facing a clearly identifiable risk of financial loss.

In response to another comment, proposed § 107.865(d)(3) has been revised by deleting the world ''original'', which SBA agrees is unnecessary. Another comment requested that temporary Control be permitted if a Licensee satisfies either of the criteria in paragraph (d)(3) instead of both. SBA considers the language in the proposed rule to be appropriate and has not adopted the comment.

Proposed paragraph (d)(4) would allow a Licensee to take temporary Control if the Financing is a Start-up Financing and the Licensee (or investor group including the Licensee) is the concern's major source of capital. It was suggested by one commenter that this paragraph should also allow temporary Control if the Financing is a ''change of Control of a Small Business pursuant to proposed § 107.750.'' SBA believes that the proposed temporary Control provisions give Licensees sufficient protection and flexibility, and is finalizing § 107.865(d) without change.

SBA received three comments on proposed § 197.865(e)(3) questioning the reduction from seven years to five years of the time limit for maintaining temporary Control (subject to an extension granted by SBA in extraordinary circumstances). One comment suggested going back to seven years, one questioned the necessity of any time limit (due to the fact that it is inherent in the venture business to want to exit investments as soon as possible), and one suggested language stating that SBA would grant an extension if a Licensee can establish ''that the relinquishment of Control will materially impair the value'' of its investment.'' SBA rejects all three of these suggestions and is finalizing § 107.865(e)(3) as proposed. Control is prohibited under the Act and SBA believes that exceptions to this prohibition must be narrowly tailored. The Agency considers the five year period sufficient in most cases and can grant exceptions if circumstances warrant.

v. Management Fees for Services Provided to Small Businesses

Three comment letters were received regarding proposed § 107.900. While one commenter approved the liberalization of the rules governing management services provided to Small Businesses, it was suggested that greater liberalization is still needed. The other two commenters argued in favor of expanding the criteria under which a Licensee could provide management services to a Financed Small Business without SBA approval. Specifically, they focused on the requirement that the Services be provided only on an hourly fee basis. They explained that the current trend is moving away from hourly billing toward ''project fees'' and that hourly billing has been perceived as being both inefficient and unfair. They further noted that while this issue can be resolved by acquiring SBA's prior written approval pursuant to proposed § 107.900(c), this process is both time consuming and burdensome. SBA has reexamined this issue in light of the comments received and recognizes the reasonableness of this suggestion. Therefore, proposed § 107.900 is revised to allow a Licensee to charge on a project fee or other reasonable basis. However, the burden of proof will be on the licensee to demonstrate, upon request, that fees charged to not exceed prevailing rates charged for comparable services by other organizations in the geographic area of this Small Business.

Paragraph (b), concerning fees for service as a board member, is revised in the final rule in accordance with comments received, to allow for fees to be paid in the form of cash, warrants or other consideration. In addition, the following language is added at the end of the last sentence of paragraph (b): ''* * * or, in the absence of outside board members, amounts reasonable when compared to similar companies with outside board members.''

Proposed § 107.900(e)(2) discusses transaction fees which may be charged a Small Business by a Licensee's Associate for services performed in connection with a public or private offering made by the Small Business or the sale of all or part of the business. The comment received on this paragraph suggested that the 95 percent unrelated revenue test was too restrictive and would force Small Businesses to hire outside investment bankers who would be unfamiliar with the company, which could result in higher fees. SBA is persuaded by this argument and has deleted this provision from paragraph (e)(2).

Except for the revisions discussed above, § 107.900 has been finalized as proposed.

8. Subpart H—Non-Leveraged Licensees—Exceptions to Regulations

Two comments were received on proposed § 107.1000. One specifically praised the flexibility embodied in the proposal, which provides a consolidated listing of those regulatory provisions from which a non-leveraged Licensee would be exempt. The other comment listed a number of sections from which non-leveraged Licensees should be exempt, but these largely involved statutory requirements. As discussed throughout this preamble, some additional provisions have been added to this section. In addition to the exemptions in the proposed rule, the final rule exempts non-leveraged Licensees from:

(1) The recordkeeping requirements and fee limitations in § 107.825(b) and (c) for securities purchased through or from an underwriter;

(2) The requirement to obtain SBA's prior approval of initial Management expenses under § 107.140 and increases in Management Expenses under § 107.520;

(3) The prior approval requirement in § 107.815(b) for options obtained from a Small Business by the Licensee's management or employees; and

(4) The requirement to obtain post approval for new directors and new officers, other than the Licensee's chief operating officer. A notification requirement has been substituted.

9. Subpart I—SBA Financial Assistance for Licensees (Leverage)

a. Types of Leverage Available

Only one comment was received on proposed § 107.1100 which strongly supported the language clarifying that a Section 301(d) Licensee may apply for both Debenture and Participating Security Leverage. The section is therefore finalized without change.

b. General Eligibility Requirements for Leverage

One comment was received on proposed § 107.1120, objecting to the presumption that only Licensees with $5 million or more of Regulatory Capital are financially viable. The commenter stated that this represents a 300 percent increase for Section 301(d) Licensees, is not warranted and threatens the financial viability of Section 301(d) Licensees. As stated previously in this preamble, SBA considers the minimum capital requirements to be vital to the sound operation of the SBIC program.

c. Requirement To File Quarterly Financial Statements

Proposed § 107.1220 requires that Licensees file quarterly, unaudited financial statements on SBA Form 468 (short form) within 30 days of the end of the quarter, so long as any part of SBA's Leverage commitment is outstanding to the Licensee. A commenter suggested, and SBA agrees, that this section should be revised to clarify that the quarterly filing requirement does not apply at the Licensee's fiscal year end, which is covered by the annual filing of Form 468 under § 107.630. The section is revised and finalized accordingly.

d. Draw-downs by Licensee Under SBA's Leverage Commitment

All three of the comment letters received on proposed § 107.1230 objected to one of the requirements listed under the ''procedures for funding draws'' in paragraph (d). As proposed, paragraph (d)(3) would require a Licensee, when requesting a ''draw'' pursuant to SBA's Leverage commitment, to furnish a statement to SBA ''that the proceeds are needed to fund one or more particular Small Business, including the name and address of each Small Business, and the amount and anticipated closing date of each proposed financing.'' One commenter labeled this paragraph an ''unnecessary burden requiring an act of prophecy.'' All agreed that as investors, they are not motivated to draw capital and not invest it, but that they may be looking at many investments at the time of the request, expecting to make one or more investments based upon proposals outstanding or being negotiated, and not all close. It was further pointed out that some negotiations may delay closing or alter amounts actually invested.

SBA considered this issue at length. As participants in the SBIC program are aware, there is insufficient Leverage currently available to meet demand, and no change is expected in the near future. This places SBA in the position of having to allocate the limited Leverage available among all the eligible applicants. Under these conditions, SBA finds it useful to be able to review each Licensee's track record in closing its anticipated investments as part of its evaluation of the Licensee's need for Leverage in comparison with others. Thus, SBA is not willing to delete the requirement for information on specific planned Financings at this time.

Nevertheless, SBA is sympathetic to the commenters' concerns and is open to future changes in this area, particularly if Leverage ceases to be in short supply. In the final rule, the information requirements in paragraph (d)(3) are preceded by the phrase ''if required by SBA''. This language gives the Agency the flexibility to drop these requirements in the future if conditions warrant, without having to revise the regulations.

e. Participating Securities—Requirement To Make Equity Capital Investments

Under proposed § 107.1500(b)(4), which was unchanged from the existing regulations, Licensees issuing Participating Securities would have been required to make Equity Capital Investments equal to the total amount of Participating Securities issued, and also to maintain Equity Capital Investments in an amount equal to their outstanding Participating Securities. SBA received a comment arguing strongly that the requirement to maintain a certain level of Equity Capital Investments should be deleted. The commenter's concern was that it is impossible to predict when investments will be liquidated and that a Licensee might fall into violation due to circumstances largely beyond its control.

SBA appreciates the commenter's concern. However, section 303(g)(4) of the Act specifically requires Licensees to ''maintain an amount equal to the outstanding face value'' of Participating Securities in Equity Capital Investments. Therefore, this requirement cannot be abandoned, and the section is finalized as proposed. However, in considering waiver requests, the Agency will give weight to circumstances which suggest that noncompliance is the result of factors not readily controllable by the Licensee.

f. Participating Securities—Liquidity Requirement

Proposed § 107.1505(a) contained language giving SBA the right to make the final determination of a Licensee's liquidity impairment. SBA received a comment suggesting that this language be deleted. SBA is persuaded that Licensees are unlikely to be motivated to manipulate the liquidity computation in order to make distributions that would leave them without sufficient liquidity to continue their operations; therefore, this language has been deleted from the final rule.

g. Participating Securities—Computation of Earmarked Profit (Loss)

In proposed § 107.1510(d), SBA attempted to provide a simplified formula for the computation of Earmarked Profit (Loss) without changing the substance of the calculation. One comment pointed out that the revised language, which referred to ''Net Income (Loss) as reported on SBA Form 468'', created ambiguity with respect to the treatment of user fees paid to SBA and partnership syndication costs incurred by Licensees. Licensees have presented these items on Form 468 using a variety of accounting treatments, and in some cases have not made them a component of Net Income (Loss).

SBA believes that Licensees should be permitted to treat both user fees and syndication costs as expenses for the purpose of determining Earmarked Profit (Loss). Accordingly, the final rule states that for the purpose of determining Net Income (Loss) in the Earmarked Profit formula, user fees and commitment fees paid to SBA, as well as partnership syndication costs, must be capitalized and amortized on a straight-line basis over five year. In all other respects, Net Income (Loss) must be as reported on SBA Form 468.

h. Participating Securities—Base for Profit Participation

Proposed § 107.1530(c) presented the formula for the Base on which a Licensee computes SBA Profit Participation. There was no change proposed in the formula; however, SBA received one comment pointing out a situation in which the formula produces an unintended result. If a Licensee were to compute and distribute Profit Participation for an interim period, and then experience losses during the remainder of its fiscal year which partially offset the interim profit, the later losses could not be included in Unused Losses for the purpose of determining the Base going forward. SBA agrees with the need for a technical correction of the Unused Loss definition, and is finalizing § 107.1530(c) with the necessary revision.

i. Participating Securities—''PLC Ratio'' Used in Profit Participation Rate Formula

Proposed § 107.1530(e)(2) set forth the conditions under which a Licensee can reduce its PLC Ratio by increasing its Leverageable Capital. A reduction of the PLC Ratio has the effect of reducing the Licensee's Profit Participation Rate. One commenter suggested that a Licensee should be permitted to include a Leverageable Capital increase in the ratio without express SBA approval, provided the increase was the result of the takedown of commitments or the conversion to cash of non-cash assets included in Private Capital. Language to this effect was previously included in the regulations and was inadvertently dropped from the proposed rule. It has been restored in the final version of § 107.1530(e)(2).

j. Participating Securities—Adjustment of Interim Profit Participation Calculations for Changes in the Year-End Profit Participation Rate

SBA received a comment suggesting that proposed § 107.1530(h)(3) be deleted. This provision, which was unchanged from the existing regulations, stated that if a Licensee computing Profit Participation had previously made an interim computation during the same fiscal year, it would be required to adjust the interim amount to account for any subsequent increases in the Profit Participation Rate. The commenter pointed out that the provision was inconsistent with the mechanics of § 107.1530(h) (1) and (2), which resulted in automatic adjustment of interim computations for subsequent increases *or decreases* in the Licensee's Profit Participation Rate.

SBA agrees that the provisions are inconsistent; however, the preamble to the April 8, 1994 final rule concerning the Participating Securities program (59 FR 16898) makes the following statement: ''Any computation of Profit Participation made as of the close of an interim fiscal quarter is subject to adjustment whenever any subsequent interim distributions are contemplated, and at the end of the fiscal year, in order to account for any increase in the Profit Participation Rate. If the Profit Participation Rate decreases as a result of an approved increase in Leverageable Capital, Profit Participations already computed for any interim periods shall not be adjusted.''

Thus, with respect to the original intent of the regulations, the error in the proposed rule is found not in paragraph (h)(3), but in paragraphs (h)(1) and (h)(2), which incorrectly adjust interim Profit Participation computations for decreases in the Rate as well as increases. Accordingly, in the final rule, SBA has revised paragraph (h) so that an adjustment takes place only when the Profit Participation Rate increases.

k. Participating Securities—Basis for Distribution of Prioritized Payments and Adjustments

Proposed § 107.1540(a), which is essentially the same as the existing regulation, would require a Licensee to distribute the balance in its Distribution Account (consisting of Earned Prioritized Payments and earned Adjustments) annually, based on its profits as determined under § 107.1520. One commenter pointed out that ''no distinction is made in § 107.1520 between cash and non-cash earnings. Consequently, this provision effectively requires that a Licensee make an annual distribution of cumulative profits to pay Prioritized Payments even if the Licensee did not receive cash for all or a portion of these profits.'' The commenter suggested that distributions should be required only for profits earned by the Licensee in cash.

SBA appreciates the concern expressed, but has decided to finalize this section as proposed. The Agency believes that Licensees are sufficiently protected by the provision in § 107.1540(a) that makes all distributions under § 107.1540 conditional upon the satisfaction of the liquidity requirement in § 107.1505. Thus, a Licensee that had received only non-cash income likely would be precluded from making a distribution.

l. Payment of Prioritized Payments on Participating Securities in Order of Issue Date

Under proposed § 107.1540(c), Licensees would be required to pay Prioritized Payments on their Participating Securities in order of the securities' issue dates. One commenter pointed out that this would impose a substantial burden by requiring Licensees to maintain detailed sub-accounts to track the Accumulated Prioritized Payments associated with each individual Participating Security, and would not provide any benefit to the Agency. SBA agrees that this provision is unnecessary and has deleted it in the final rule.

m. Participating Securities—Computation of ''Maximum Tax Liability''

Proposed § 107.1550(b) set forth the formula used to compute a Licensee's Maximum Tax Liability, from which the Licensee calculates its permitted tax distribution. One element in the formula is ''total ordinary income'' allocated to Licensee's investors for Federal income tax purposes. One commenter sought clarification as to whether this phrase was intended to represent ordinary income less ordinary deductions. That is the interpretation intended by SBA, and the paragraph has been revised in the final rule to clarify the meaning.

With respect to the same paragraph, the commenter also suggested that ''total ordinary income'' be defined to exclude expenses that partners may not be able to deduct fully under the tax law. SBA believes this suggestion is inconsistent with the Act, which refers to ''income allocated to each partner or shareholder * * * for Federal income tax purposes'' and does not provide for any adjustment for nondeductible expenses. Furthermore, the Agency finds no compelling reason to provide all investors with an additional benefit based on the possibility that some may face limitations on their deductions.

n. Participating Securities—Payment Dates

SBA received several comments concerning the Participating Security distribution regulations (§§ 107.1540 through 107.1570) which would require Licensees to make distributions only on quarterly Payment Dates. All the commenters objected to the inflexibility of these provisions. As stated in the preamble to the proposed rule, the Payment Dates represent the dates on which Trust Certificate holders receive interest payments and any returns of principal to which they are entitled. Because Participating Securities can be redeemed only on Payment Dates, the proposed rule limited Licensees' distributions to these dates to avoid certain problems, such as the question of who is responsible for Prioritized Payments on a Participating Security during the interval between the making of a distribution and the actual redemption of the Participating Security with the proceeds of the distribution.

However, SBA recognizes that the loss of flexibility under the Payment Date structure can have a significant negative impact on both the Licensee and the Agency, particularly in the case of distributions to be made in the form of securities. In this instance, the restrictions may force the Licensee to hold securities for a substantial period of time, during which the Licensee and its investors (including SBA) would be subject to a high degree of market risk.

Because of time constraints, SBA is unable to modify the Payment Date restrictions in this final rule. However,

the Agency intends to seek a solution that will provide Licensees with greater flexibility in making distributions of securities, and to publish a proposed rule dealing with this problem as soon as possible.

One change concerning the timing of distributions is being incorporated in the final rule. In the preamble to the proposed rule, SBA indicated that it was willing to consider allowing tax distributions under § 107.1550 to be made during some window period between the February 1 and May 1 Payment Dates, in order to allow investors to receive cash before their Federal tax filing deadlines. Based on the comments received, SBA is finalizing § 107.1550(d) with revised language permitting a tax Distribution to be made between March 1 and April 15 by a Licensee with a December 31 year end. Licensees still must pay all Prioritized Payments before being eligible to make a tax distribution.

o. Trust Certificates

During the comment period, SBA reviewed proposed §§ 107.1600 through 107.1680 pertaining to Trust Certificates guaranteed by SBA to fund Leverage. Section 321 of the Act and the documentation of the Trust Certificates are very specific with respect to the terms and conditions. SBA has chosen to shorten these sections by eliminating language contained in the statute or detailed in the Trust Certificates. None of the changes made to the proposed §§ 107.1600 through 107.1680 are substantive. In the final rule, Trust Certificates are covered in renumbered §§ 107.1600 through 107.1640.

p. Miscellaneous Leverage Provisions

In the final rule, SBA has eliminated proposed § 107.1700(a) and (c) as redundant and unnecessary language. Section 321(a) of the Act is specific with respect to SBA's unconditional guarantee and the requirement for a bond. SBA will continue to provide for an unconditional guarantee. The bonding requirement has been eliminated in this section as well as in the Trust Certificate sections because the bond is required by statute.

10. Subpart J—Licensee's Noncompliance With Terms of Leverage

a. Capital Impairment

SBA received one comment on proposed § 107.1840(d)(6), which would have required a Licensee, in computing its Capital Impairment Percentage, to reduce its ''Adjusted Unrealized Gain'' by the amount of any borrowing or other obligation associated with portfolio securities that were the source of the Unrealized Appreciation used as the basis for determining the Adjusted Unrealized Gain. The commenter correctly pointed out that the reduction should be limited to the extent of the Unrealized Appreciation. SBA agrees and has finalized the provision accordingly.

11. Appendices to Part 107

The existing regulations include two appendices: Appendix I, Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies, and appendix II, Valuation Guidelines for SBICs. SBA has decided to delete the appendices from Part 107, and will publish them in a different format at a later date. Although they are no longer part of the regulations themselves, both the accounting standards and the valuation guidelines remain applicable to all Licensees.

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 final rule will not be a significant regulatory action for purposes of Executive Order 12866 because it will not have an annual effect on the economy of more than $100 million, and that it will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*

The primary purpose of the rule is to streamline the regulations governing the SBIC program by eliminating obsolete regulations and reorganizing the remainder in a more logical and readable format.

Two areas of the regulations will have some economic effect, including possible effects on small entities. First, license application fees and examination fees will be raised. An SBIC license applicant will pay a fee of $10,000 to $20,000, compared with the current $5,000. This increase is not significant relative to the private capital of an average Licensee, which exceeds $10 million. Exam fees will continue to be based on the total assets of a Licensee, but at higher rates. The largest Licensees, generally those with several hundred million dollars of assets, could experience fee increases of $20,000 or more; however, the number of such Licensees is currently very small.

Second, the changes in the regulations governing ''Cost of Money'' (the maximum amount a Licensee can charge on loans and debt securities) will potentially affect the borrowing costs of small entities. Although the interest rate on loans is determined primarily by market forces, the final rule will raise the interest rate ceiling on loans extended by Licensees from 15 percent to 19 percent. The total amount of loans provided to small businesses by Licensees is approximately $240 million per year. Even if the additional four percentage points were charged on the entire balance of such loans, the annual economic impact would be less than $10 million.

For purposes of the Paperwork Reduction Act, 44 U.S.C. Ch. 35, SBA certifies that this final rule contains no new reporting or record keeping requirements that have not already been approved by the Office of Management and Budget. The ''Financing Eligibility Statement'' (SBA Form 1941) which is required under § 107.610 has already been approved by OMB under Control Number 3245–0301.

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

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

List of Subjects in 13 CFR Part 107

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

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

BILLING CODE 8025–01–M

PART 107—SMALL BUSINESS INVESTMENT COMPANIES

Subpart A—Introduction to Part 107

Sec.
107.20 Legal basis and applicability of this part 107.
107.30 Amendments to Act and regulations.
107.40 How to read this part 107.

Subpart B—Definition of Terms Used in Part 107

107.50 Definition of terms.

Subpart C—Qualifying for an SBIC License

Organizing an SBIC
107.100 Organizing a Section 301(c) Licensee.
107.110 Organizing a Section 301(d) Licensee.
107.115 1940 Act and 1980 Act Companies.
107.120 Special rules for a Section 301(d) Licensee owned by another Licensee.