

**SMALL BUSINESS ADMINISTRATION****13 CFR Part 107**

RIN 3245-AG32

**Small Business Investment Companies—Early Stage SBICs****AGENCY:** U.S. Small Business Administration.**ACTION:** Proposed rule.

**SUMMARY:** In this proposed rule, the U.S. Small Business Administration (SBA) is defining a new sub-category of small business investment companies (SBICs) which will focus on making equity investments in early stage small businesses. By licensing and providing SBA leverage to these “Early Stage SBICs,” SBA seeks to expand entrepreneurs’ access to capital and encourage innovation as part of President Obama’s Start-Up America Initiative launched on January 31, 2011. This proposed rule also sets forth regulations applicable to Early Stage SBICs with respect to licensing, capital requirements, non-SBA borrowing, examination fees, leverage eligibility, distributions, and capital impairment. In addition, this proposed rule makes certain technical changes to SBA regulations.

**DATES:** Comments must be received on or before February 7, 2012.

**ADDRESSES:** You may submit comments, identified by RIN 3245-AG32, by any of the following methods:

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *Mail, Hand Delivery/Courier:* Sean Greene, Associate Administrator for Investment, U.S. Small Business Administration, 409 Third Street SW., Washington, DC 20416.

SBA will post all comments to this proposed rule without change on <http://www.regulations.gov>. If you wish to submit confidential business information (CBI) as defined in the User Notice at <http://www.regulations.gov>, please submit the information to Carol Fendler, Investment Division, 409 Third Street SW., Washington, DC 20416. Highlight the information that you consider to be CBI and explain why you believe this information should be held confidential. SBA will review the information and make the final determination of whether it will publish the information or not.

**FOR FURTHER INFORMATION CONTACT:** Carol Fendler, Investment Division, (202) 205-7559 or [sbic@sba.gov](mailto:sbic@sba.gov).

**SUPPLEMENTARY INFORMATION:**

**I. Background Information**

On January 31, 2011, President Obama announced the “Start-Up America Initiative” to encourage American innovation and job creation by promoting high-growth entrepreneurship across the country with new initiatives to help encourage private sector investment in job-creating startups and small firms, accelerate research, and address barriers to success for entrepreneurs and small businesses. The SBIC program will play a key role in accomplishing these goals by expanding access to capital for early stage businesses.

Early stage businesses face difficult challenges accessing capital, particularly those without the necessary assets or cash flow for traditional bank funding. Although the venture capital industry provided over \$22 billion in financings to U.S. businesses in calendar year 2010, this represented over a 23% decline from 2007. Less than a third of these financing dollars went to early stage or start-up businesses. Of the financings that went to early stage and start-up, over two-thirds went to businesses located in three states: California, Massachusetts, and New York. (Source: ThomsonOne VentureXpert) As a result, less than 10% of U.S. venture financing dollars went to early stage and start-up businesses not in those three states. SBA will seek to expand access to capital for early stage small businesses throughout the United States by allocating from its current debenture authorization up to \$200 million per year (up to \$1 billion total over five years) beginning in FY 2012 to Early Stage SBICs.

SBA has not typically provided leverage in the form of SBA-guaranteed debentures to SBICs that plan to provide early stage venture capital financing to small businesses. The standard debenture is generally appropriate for investments in small businesses that generate sufficient cash flow to pay interest and/or dividends, so that SBICs in turn can make semi-annual interest payments on their debentures. Investments in early stage companies, which typically cannot make current interest or dividend payments, do not fit naturally with the structure of debenture leverage.

Furthermore, early stage companies have inherently higher risk; although they can offer potentially higher returns than later stage equity or mezzanine debt investments, the returns are much more volatile. Because the debenture program is required by law to operate at zero cost to taxpayers, the Early Stage SBIC initiative contemplates a number

of strategies to mitigate risk and limit the initiative’s impact on leverage fees, although fee increases will still be necessary. First, SBA intends to limit the amount of debenture leverage available to Early Stage SBICs to a small percentage of SBA’s overall portfolio. Second, SBA is proposing several new regulatory provisions to reduce the risk that an Early Stage SBIC will default on its leverage and to improve SBA’s recovery prospects when a default does occur. Third, SBA intends to act immediately to declare an event of default when an Early Stage SBIC has a condition of Capital Impairment and to exercise all available remedies, including acceleration of the Early Stage SBIC’s leverage, if the default is not cured within the allotted time (see existing §§ 107.1830 and § 107.1810(f) and (g)). SBA is not proposing to change the current maximum permitted Capital Impairment Percentages set forth in § 107.1830 and expects that, for most Early Stage SBICs, the applicable percentage would be 70 percent.

Once the Early Stage initiative has been implemented, the actual performance of Early Stage SBICs would become a factor in the annual adjustment of leverage fees to maintain the overall debenture program at zero taxpayer cost.

To provide Early Stage SBICs with added flexibility, SBA expects to make two forms of leverage available to them: a debenture that requires quarterly interest payments throughout its term, and a debenture that is issued at a discount and does not require interest payments during the first five years of its term. Both debentures would have a 10-year maturity and would be subject to the SBA leverage fee structure currently in effect, including a 3 percent origination fee and an annual charge that is adjusted at the beginning of each fiscal year and applied to new leverage commitments issued in that year.

**II. Section by Section Analysis****A. Early Stage Initiative Provisions**

*Section 107.50—Definitions.* To implement the Early Stage initiative, SBA proposes to add the defined term “Early Stage SBIC” and revise the existing defined term “Payment Date”.

**Early Stage SBIC**

The regulatory definition of Early Stage SBIC has several key points. First, an Early Stage SBIC must be organized as a limited partnership. Although the current regulations permit other forms of organization, the vast majority of existing SBICs are limited partnerships. SBA believes that having a degree of

uniformity in organizational structure will facilitate a more efficient licensing process for Early Stage SBICs.

Second, the definition makes clear that the “Early Stage SBIC” designation would apply only to SBICs licensed pursuant to the new provisions in this rule. The SBIC program currently includes, and SBA continues to license, SBICs that make at least some early stage investments. With few exceptions, these funds are either: (1) “Non-leveraged” SBICs, which use only private investor capital to make investments, (2) older SBICs that used SBA leverage in the form of participating securities, which are no longer available, or (3) SBICs using debenture leverage that make a few early stage investments as part of their portfolio. Such SBICs are excluded from the “Early Stage SBIC” definition.

Third, an Early Stage SBIC must invest at least 50 percent of its financing dollars in small businesses that are classified as “early stage” at the time of the SBIC’s initial investment. SBA believes that the 50 percent threshold indicates a significant focus, while still giving SBICs flexibility in developing their portfolios. Since a key goal of the Early Stage initiative is to promote the growth of early stage businesses, any follow-on investments in a portfolio company that was “early stage” at the time of the SBIC’s initial investment would count towards the 50 percent requirement.

Fourth, a small business would be considered “early stage” if it has not yet achieved positive cash flow from operations in any full fiscal year. A start-up company with no prior operating history may qualify under this definition. The venture capital industry employs various definitions of “early stage”, most of which describe a business with or without revenues that is not yet profitable or generating positive cash flow. SBA chose to define early stage companies based on operating cash flow because it is less vulnerable to manipulation or distortion than other measures and because the availability of adequate cash is crucial to a business’s ability to survive. Although definitions of “early stage” sometimes include the number of years the company has been in business, SBA did not include age as a factor. Many companies develop slowly over a number of years before they are positioned to grow significantly, and SBA believes that the definition should not exclude such companies.

#### Payment Date

SBA is proposing special distribution rules (see proposed § 107.1180) for Early

Stage SBICs which would require Early Stage SBICs to make mandatory prepayments of outstanding debentures at the same time they make distributions to their private limited partners. The proposed revision of the “Payment Date” definition in § 107.50 would designate March 1, June 1, September 1, and December 1 of each year as the dates on which debenture prepayments can be made and required interest payments will be due.

*Section 107.210—Minimum capital requirements for Licensees.* Proposed § 107.210(a)(3) would require an Early Stage SBIC to have at least \$20 million of Regulatory Capital (consisting of paid-in capital contributions from private investors plus binding capital commitments from Institutional Investors, as defined in existing § 107.50). In comparison, the minimum Regulatory Capital is \$5 million for other debenture SBICs and \$10 million for participating securities SBICs. SBA considered a number of factors in setting the \$20 million threshold. First, Early Stage SBICs will have access to at most one “tier” of leverage (a one-to-one match between leverage and private capital), while most other SBICs have access to at least two tiers. Second, historical data show that SBA has experienced higher loss rates on smaller SBICs, with performance statistics improving as private capital approaches \$20 million. Third, SBA attaches high importance to the market validation evidenced by the ability of an Early Stage SBIC’s management team to raise funds from private investors. Although SBA believes the overall \$40 million in total capital (private capital plus leverage) is appropriate to manage fund risk, SBA requests public input on the \$20 million private capital minimum.

The proposed rule does not require an Early Stage SBIC applicant to have \$20 million of Regulatory Capital at the time of application, only at the time of licensing and thereafter. However, the time available for additional fundraising after submission of an application may be limited, and SBA may require evidence of fundraising progress at the time of application. SBA expects to provide further details regarding the Early Stage SBIC application process via **Federal Register** notice prior to accepting Early Stage SBIC applications.

*Section 107.300—License application form and fee.* This section includes a technical correction and clarification, as well as a proposed substantive change. The current regulation refers to SBA Form 415, an old SBIC license application form. This outdated reference would be replaced by the correct reference to current SBA Forms

2181 (the license application) and 2182 (exhibits to the license application). The proposed rule would also clarify that the licensing fee is non-refundable, consistent with longstanding SBA policy. Finally, because Early Stage SBICs would require special processing, proposed § 107.300(d) would require such applicants to pay an additional licensing fee of \$10,000, bringing their total licensing fee to \$25,000.

*Section 107.305—Evaluation of license applicants.* Proposed § 107.305 discusses the factors used by SBA to evaluate applicants to the SBIC program, including applicants for an Early Stage SBIC license, which are grouped in four broad categories: Management qualifications, performance of managers’ prior investments, the applicant’s proposed investment strategy, and the applicant’s proposed organizational structure and fund economics. Although this section would be a new addition to the regulations, it does not represent a change in SBA’s licensing criteria. Rather, it would improve public access to useful information about the SBIC program by including it in the regulations along with the other requirements for obtaining an SBIC license (minimum private capital requirements, management-ownership diversity, *etc.*). SBA may still issue further guidance to potential applicants in other formats, as needed. SBA requests input from the public on these evaluation criteria.

*Section 107.310—When and how to apply for licensing as an Early Stage SBIC.* Because SBA plans to commit only \$200 million of leverage per year to Early Stage SBICs, demand may exceed supply. Under proposed § 107.310, SBA would not license two Early Stage SBICs under common control if both would have SBA leverage or leverage commitments outstanding at the same time. For example, the same managers could not receive two licenses at the same time or in close proximity, but could seek a second license after their first fund had repaid all of its leverage and did not intend to seek any more. By limiting the amount of leverage in the hands of one owner or management group, this restriction would improve diversification of SBA’s overall Early Stage SBIC portfolio. In addition, the proposed section provides that SBA would accept Early Stage SBIC applications only during specified periods, which would be announced by **Federal Register** notice. By creating periodic application windows, SBA will be able to gauge the overall demand for leverage and allocate the available funds among all successful applicants. Up to

a maximum of \$50 million per fund, SBA intends to make one full tier of leverage available to each licensed Early Stage SBIC (unless the SBIC requests less) and will stop licensing new funds when the aggregate private capital of existing licensees is sufficient to utilize all of the leverage (up to \$1 billion in total) allocated to the Early Stage initiative. Depending on demand, SBA may need to commit leverage to Early Stage SBICs in tranches spread over several years, rather than providing a full one-tier commitment at the time of licensing.

*Section 107.320—Evaluation of Early Stage SBICs.* Proposed § 107.320 states that SBA would evaluate Early Stage SBIC applicants using the same set of factors applicable to SBIC applicants in general, as set forth in proposed § 107.305. This does not mean that a successful debenture SBIC applicant and a successful Early Stage SBIC applicant would look similar. Rather, it means that each applicant's investment strategy must be appropriate for the type of SBA leverage it intends to use, and each applicant's management team must have a successful investment track record that is relevant to its strategy. Early Stage applicants will need to demonstrate superior qualifications in the key areas identified in the proposed rule. SBA will not relax licensing standards to achieve numerical licensing goals or ensure that the full amount allocated to the Early Stage initiative is used.

Proposed § 107.320(a) and (b) would add two selection criteria specific to Early Stage SBICs. For risk management purposes, SBA considers it important to have adequate diversification of Early Stage SBICs with respect to "vintage year" (the year in which an investment fund draws its initial capital from investors). Because of the cyclical nature of venture capital, vintage year has a major impact on the return expectations of a fund and excessive concentration in a single year could substantially increase program risk. Therefore, SBA will reserve the right, when licensing Early Stage SBICs, to maintain diversification across vintage years.

Similarly, SBA will reserve the right to maintain diversification of Early Stage SBICs with respect to geographic location. SBA's primary concern in terms of geography is to ensure that the Early Stage initiative includes assistance to small businesses located in areas outside the traditional hubs for venture capital investment.

SBA expects that the Early Stage licensing process, like the standard SBIC licensing process, will have two

phases: (1) An initial review focused primarily on management qualifications and planned investment strategy, for which applicants submit a Management Assessment Questionnaire (MAQ); and (2) a licensing phase requiring submission of a complete license application, including the licensing fee, organizational documents for the proposed SBIC, principals' fingerprints and personal history statements that will be used to perform criminal history checks, and evidence that the applicant has raised sufficient private capital to carry out its business plan. Applicants who submit a MAQ in the first phase progress to the second phase only if SBA issues a "green light" letter inviting them to do so. In the standard licensing process, the green light letter is valid for 18 months, allowing the applicant time to raise private capital and prepare the full application. In the interests of making capital available to early stage small businesses as quickly as possible, SBA expects to have a more compressed licensing process for Early Stage SBICs. Although applicants may be able to continue their fundraising activities for a limited time after submitting an application, SBA anticipates that they will be required to show substantial progress towards their targeted private capital by the application deadline. After this rule has been finalized, SBA intends to publish a **Federal Register** notice with further details regarding licensing of Early Stage SBICs, including the period during which applications will be accepted.

*Section 107.565—Restrictions on third-party debt of Early Stage SBICs.* Proposed new § 107.565 would apply to any non-SBA debt of an Early Stage SBIC. Current § 107.550 requires an SBIC with outstanding leverage to obtain SBA's prior written approval of any secured third party debt, but no approval is required for unsecured debt. The proposed rule would require an Early Stage SBIC to obtain SBA approval to have, incur or refinance any third-party debt, even if it is unsecured. SBA believes this is a prudent restriction for Early Stage SBICs because of their higher risk profile. Even debt that is unsecured increases SBA's credit risk because SBA leverage is never senior to the claims of other unsecured creditors: The first \$10 million of SBA leverage is generally subordinated to other unsecured debt of an SBIC, and leverage above \$10 million is pari passu with other unsecured debt.

*Section 107.585—Voluntary decrease in Licensee's Regulatory Capital.* The current regulation permits an SBIC to reduce its Regulatory Capital by as much as two percent in any fiscal year.

Any reduction in excess of two percent requires SBA's prior written approval. A reduction in Regulatory Capital typically occurs when an SBIC returns capital to its investors. SBA is proposing special distribution rules for Early Stage SBICs to mitigate the additional risk associated with early stage investing (see proposed § 107.1180). To avoid any possible inconsistency between current § 107.585 and proposed § 107.1180, the proposed rule would require any reduction of Regulatory Capital under § 107.585 by an Early Stage SBIC to be approved by SBA in writing.

*Section 107.692—Examination fees.* SBA intends to closely monitor the performance of Early Stage SBICs to help manage the higher risk associated with early stage investing. All SBICs undergo periodic regulatory compliance examinations, and SBA expects that examinations of Early Stage SBICs will include particular attention to the value of unrealized investments. Under the proposed amendments to § 107.692, SBA would charge Early Stage SBICs an examination fee that is 10 percent higher than the base fee until all debenture leverage has been repaid and no further leverage will be issued. This is the same fee structure applied to participants in SBA's Participating Securities SBIC program.

*Section 107.1120—General eligibility requirements for Leverage.* Proposed paragraph (k) of this section would provide for a new certification by Early Stage SBICs seeking an SBA leverage commitment or draw. The Early Stage SBIC would be required to certify that it will provide at least 50 percent of the aggregate dollar amount of its financings to "early stage" companies, in accordance with the Early Stage SBIC definition in § 107.50. SBA seeks input from the public on whether 50% minimum is an appropriate level of early stage investments. SBA has proposed a prospective certification, rather than a certification stating that the Early Stage SBIC currently complies with the early stage investment requirement, to provide flexibility for a fund to take advantage of good investment opportunities when they occur. SBA intends to monitor Early Stage SBICs' performance in making early stage investments, and would treat a failure to meet the 50 percent requirement as an event of default under an Early Stage SBIC's leverage (see proposed § 107.1810(f)(11)).

*Section 107.1150—Maximum amount of Leverage for a Section 301(c) Licensee.* In this section, SBA is proposing special limits on the maximum amount of leverage that will be available to an Early Stage SBIC.

First, the maximum amount that SBA would commit to an Early Stage SBIC on a lifetime basis would be 100 percent of the SBIC's highest Regulatory Capital or \$50 million, whichever is less. In addition, the maximum leverage that an Early Stage SBIC could have outstanding at any time would be limited to 100 percent of its paid-in private capital ("Leverageable Capital") or \$50 million, whichever is less. Finally, the cumulative amount of leverage drawn by an Early Stage SBIC could not exceed the cumulative amount of private capital paid into the fund by its investors. The reason for these limits is two-fold. First, early stage investing is an inherently high risk activity. Second, SBA plans to allocate a relatively small amount of leverage to the Early Stage initiative (up to \$200 million per year over five years). Under the existing rules for leverage eligibility, which permit a single SBIC to have outstanding leverage of up to \$150 million, the entire allocation could be used up by a very small number of SBICs, resulting in insufficient portfolio diversification and increased risk to SBA. Although a leverage ceiling of less than \$50 million per fund would improve diversification still further, SBA believes a lower limit could make the Early Stage initiative unattractive to many prospective fund managers and investors.

*Section 107.1180—Required distributions to SBA by Early Stage SBICs.* In this section, SBA is proposing to add distribution requirements that would apply only to Early Stage SBICs. The current regulations generally allow a debenture SBIC to distribute profits to its investors, with no obligation to prepay debentures prior to their maturity date (although SBICs may prepay debentures in whole at any time without penalty). SBA believes that applying these rules to Early Stage SBICs would result in an unacceptably high risk of default. Compared to most debenture SBICs, the returns realized by Early Stage SBICs are expected to be irregular and unpredictable, with a few investments producing large profits while many other investments may result in complete or partial losses. Depending on when profits are realized, the existing distribution rules could result in losses to SBA even if an Early Stage SBIC generates positive returns overall. For example, an Early Stage SBIC that earned large profits early in its life could distribute all of those profits to its private investors, assuring them of a net positive return on their investment, and thereafter perform poorly and default on its SBA leverage.

To reduce this type of risk, the proposed rule would require an Early Stage SBIC to make a distribution to SBA whenever it makes a distribution to its investors. Distributions could be made on any quarterly Payment Date (March 1, June 1, September 1, or December 1). SBA would apply any such distribution to the repayment of the SBIC's outstanding debentures. Proposed § 107.1180(b) states that all distributions to SBA would be applied to repayment of outstanding debentures in the same order as they were issued. Like other debenture leverage, debentures issued by Early Stage SBICs could be prepaid in whole but not in part. Under proposed § 107.1180(c), payment of all interest and Charges due and payable on outstanding debentures would be required as a condition of making a distribution; such interest and Charges could be paid either prior to or simultaneously with a distribution.

Proposed § 107.1180 would apply equally to all distributions, including distributions of profits and returns of invested capital. However, Early Stage SBICs would still be subject to § 107.585 (as revised by this proposed rule), which limits an SBIC's ability to reduce its Regulatory Capital. The practical effect of this limitation is that an Early Stage SBIC would have to obtain SBA's prior written approval for any distribution that is not from profits. For a distribution that is from profits, an Early Stage SBIC must notify SBA in writing at least 10 business days before the planned distribution date.

SBA's share of a distribution would depend on the Early Stage SBIC's "highest ratio" of outstanding leverage to Leverageable Capital, and its Capital Impairment Percentage (CIP), as determined under existing § 107.1840. Under proposed § 107.1180(d)(2)(i), if the CIP is less than 50 percent, distributions would be allocated pro rata (based on the "highest ratio") between SBA (up to the amount of the outstanding debenture leverage) and the Early Stage SBIC's investors. For example, if an Early Stage SBIC with a CIP of less than 50 percent has \$25 million of contributed capital from its investors and has drawn \$25 million of leverage from SBA, the distribution would be allocated 50% to the investors and 50% to SBA. If the Early Stage SBIC has \$30 million of contributed capital from its investors and has drawn only \$20 million of leverage from SBA, the distribution would be allocated 60% to the investors and 40% to SBA. An Early Stage SBIC's "highest ratio" of outstanding leverage to Leverageable Capital, rather than the ratio at the time of the distribution, will be used to

determine SBA's share of a distribution. Thus, even if the Early Stage SBIC repays SBA leverage or other events occur that cause a reduction in the Early Stage SBIC's ratio of outstanding leverage to Leverageable Capital, it would continue to base the allocation of future distributions on the "highest ratio" rather than the current ratio.

Under proposed § 107.1180(d)(2)(ii), if the CIP reached 50 percent or more, SBA would receive 100 percent of any distribution until all outstanding debentures have been repaid. However, if the Early Stage SBIC reduces its CIP below 50 percent, it could resume distributions to its investors, as described above. SBA expects that all or nearly all Early Stage SBICs will have a maximum allowable CIP of 70 percent, as determined under existing § 107.1830, so a 50 percent CIP would not indicate a condition of Capital Impairment. However, SBA believes that its ability to take priority in distributions when the CIP reaches 50 percent is an appropriate risk reduction measure for the Early Stage initiative, based on historical data showing that a high proportion of SBICs that reach a 50 percent CIP go on to exceed their maximum allowable CIP.

Proposed § 107.1180(d)(3) and (d)(4) would provide for a "true-up" of cumulative distributions each time an Early Stage SBIC makes a distribution. SBA believes that with the true-up, the proposed distribution rules would operate more consistently, with fewer distortions created by differences among SBICs in the timing of gains and losses.

Proposed § 107.1180(d)(3) would multiply an Early Stage SBIC's total cumulative distributions (including the SBIC's current proposed distribution) by SBA's percentage share of cumulative distributions calculated under § 107.1180(d)(2). The sum of all prior distributions to SBA would then be subtracted from this cumulative result to calculate the amount distributable to SBA under proposed § 107.1180(d)(4). Under proposed § 107.1180(d)(5), the actual dollar amount to be distributed to SBA would be the smallest of three figures: The amount calculated under § 107.1180(d)(4); the total amount of the SBIC's planned distribution; and the total debenture leverage outstanding.

Following is an example of the distribution mechanics for an Early Stage SBIC with a "highest leverage ratio" of 1:

*First distribution:* SBIC's outstanding leverage and Leverageable Capital are both equal to \$5 million and its CIP is zero. The SBIC wants to distribute profits of \$20 million. The SBIC is current on all debenture interest and

fees. On a pro rata basis, SBA and the SBIC's investors would each receive 50 percent of the distribution, or \$10 million. However, the most that SBA can receive is \$5 million, the total amount of leverage outstanding. Therefore, the SBIC's investors would receive \$15 million.

*Second distribution:* SBIC's outstanding leverage is \$15 million, Leverageable Capital is \$20 million, and

CIP is zero. The SBIC wants to distribute profits of \$10 million. The SBIC's highest leverage ratio remains at 1. Total cumulative distributions (prior and current) equal \$30 million, of which SBA's share under § 107.1180(d)(3) would equal \$15 million. Under § 107.1180(d)(4), the \$5 million that SBA received from the first distribution must then be subtracted from the \$15 million. The result, \$10 million, is the

smallest of the three amounts under proposed § 107.1180(d)(5), so SBA would receive \$10 million and the SBIC's investors would receive no distribution. On a cumulative basis, SBA and the investors would have received \$15 million each that shows each step of the calculation listed in Table 1, Early Stage SBIC Distribution Example:

TABLE 1—EARLY STAGE SBIC DISTRIBUTION EXAMPLE  
(Dollars in millions)

|   | Distribution 1 | Distribution 2 |
|---|----------------|----------------|
| (1) Leverageable capital .....  | \$5.0          | \$20.0         |
| (2) Outstanding leverage .....  | 5.0            | 15.0           |
| (3) Cumulative leverage issued .....                                  | 5.0            | 20.0           |
| (4) Leverage ratio .....  | 1.00           | 0.75           |
| (5) Current proposed distribution .....                               | 20.0           | 10.0           |
| (6) Cumulative distributions .....                                    | 20.0           | 30.0           |
| (7) Highest leverage ratio .....                                      | 1.00           | 1.00           |
| (8) Capital impairment percentage .....                               | 0%             | 0%             |
| (9) [Highest Leverage Ratio/(Highest Leverage Ratio + 1)] × 100 ..... | 50.0%          | 50.0%          |
| (10) Line (6) × Line (9) .....  | 10.0           | 15.0           |
| (11) Prior distributions to SBA .....                                 | 0.0            | 5.0            |
| (12) Line (10) minus Line (11) .....                                  | 10.0           | 10.0           |
| (13) Amount of distribution to SBA equals least of: .....             |                |                |
| (i) Line (12) .....   | 10.0           | 10.0           |
| (ii) Line (5) .....   | 20.0           | 10.0           |
| (iii) Line (2) .....  | 5.0            | 15.0           |
| SBA's Share of Distribution .....                                     | 5.0            | 10.0           |
| Investors' Share of distribution .....                                | 15.0           |                |
| Post Distribution: Cumulative Distributions to SBA .....              | 5.0            | 15.0           |
| Cumulative Distributions to investors .....                           | 15.0           | 15.0           |

Proposed § 107.1180(e) would allow an Early Stage SBIC to prepay debenture leverage in order of issue without making any distribution to its investors. This type of voluntary prepayment could be made on any quarterly Payment Date.

*Section 107.1181—Interest reserve requirements for Early Stage SBICs.* This section would require an Early Stage SBIC to maintain funds in reserve to cover interest and Charges on its outstanding debentures. This provision is an important element of risk management for the Early Stage initiative because Early Stage SBICs are not expected to generate current interest or dividend income, which for most debenture SBICs is the primary source of cash used to service their SBA debt.

SBA expects that some Early Stage SBICs will seek SBA leverage in the form of a discounted debenture, which will not require cash interest payments during the first five years of its term. Instead, the proceeds received by the Early Stage SBIC when the debenture is issued will be discounted; over the first five years following issuance, the carrying value of the debenture will

accrete until it reaches face value, and semi-annual interest payments will be required beginning in year six. No interest reserve will be required for these discounted debentures.

For standard debentures, an Early Stage SBIC would be required to maintain a reserve equal to the total interest and annual Charge that will be payable on each such debenture over the first five years of its term. The reserve may consist of binding unfunded commitments from the Early Stage SBIC's Institutional Investors and/or "restricted" cash held by the Early Stage SBIC. Neither such unfunded commitments nor such restricted cash could be used for any purpose other than payment of interest, Charges, and any other amounts due to SBA. Restricted cash would be held in a separate bank account and reported separately from other cash in the Early Stage SBIC's financial statements. The required reserve associated with an individual debenture would be reduced on each Payment Date as the Early Stage SBIC made the required payment of interest and Charges. Furthermore, if the Early Stage SBIC prepaid a debenture,

the reserve requirement associated with that debenture would be correspondingly eliminated. The interest reserve requirement and the associated restrictions on the general partner's ability to call capital would have to be included in the Early Stage SBIC's limited partnership agreement.

*Section 107.1182—Valuation requirements for Early Stage SBICs based on Capital Impairment Percentage.* This section would require an Early Stage SBIC to notify SBA in writing if it has a Capital Impairment Percentage of at least 50 percent, even if its maximum allowable CIP is higher. When SBA receives this notification, or makes its own determination that the CIP is at least 50 percent, SBA would have the right to require the Early Stage SBIC to engage a third party valuation expert, acceptable to SBA, to perform valuations of some or all of the licensee's investments, as determined by SBA. This provision would give SBA an important monitoring tool to guide decision-making with respect to Early Stage SBICs that have begun to experience some financial difficulty.

*Section 107.1810—Events of default and SBA’s remedies for Licensee’s noncompliance with terms of Debentures.* SBA is proposing four changes in this section that would apply only to Early Stage SBICs. First, existing § 107.1810(f)(2) provides that an improper distribution made by an SBIC is an event of default. Proposed § 107.1810(f)(2)(iv) would add distributions by Early Stage SBICs, as permitted under proposed § 107.1180, to the list of specific distributions that would *not* be considered improper distributions.

Second, under proposed new § 107.1810(f)(11), it would be an event of default if an Early Stage SBIC fails to meet the requirement to invest at least 50 percent of its financing dollars in early stage companies, as defined under the proposed Early Stage SBIC definition in § 107.50. This provision would require an Early Stage SBIC to meet the 50 percent requirement as soon as the total dollars invested to date are equal to or greater than Regulatory Capital. At that point, a typical Early Stage SBIC would have deployed at least half of its total funds available for investment and thus would have had ample opportunity to seek a variety of investment opportunities. Third, under proposed new § 107.1810(f)(12), it would be an event of default if an Early Stage SBIC fails to maintain the interest reserve required under proposed § 107.1181, as discussed earlier in this preamble.

The conditions in proposed § 107.1810(f)(11) and (f)(12) would both be in the category of events of default with opportunity to cure. If the Early Stage SBIC fails to cure to SBA’s satisfaction, SBA could invoke the remedies in existing § 107.1810(g), which include the right to declare outstanding debenture leverage immediately due and payable.

Finally, proposed new § 107.1810(j) would provide SBA with additional remedies to help maximize recoveries from Early Stage SBICs that have been transferred to a liquidation status. Under this section, if SBA must honor its guarantee and pay the principal of an Early Stage SBIC’s debentures, upon such payment SBA would have the right to prohibit the SBIC from making additional investments without SBA approval (except for any investments the SBIC had already legally committed itself to make); to prohibit Distributions by the SBIC to any party other than SBA until all leverage and other amounts due to SBA have been repaid; to require all the SBIC’s investor commitments to be funded at the earliest time(s) permitted under the SBIC’s limited partnership

agreement and other applicable documents; to review and re-determine the SBIC’s approved Management Expenses (as defined in existing § 107.520); and to the appointment of SBA or its designee as receiver for the SBIC. The receivership would be for the purpose of continuing the SBIC’s operations; the appointment of a liquidating receiver is governed by existing provisions of the Small Business Investment Act and is not affected by this proposed rule.

#### *B. Technical Changes to Regulations*

*Section 107.130—Requirement for qualified management.* SBA is proposing one clarification in this section. The current regulation provides that an applicant must show “[w]hen applying for a license” that it has a qualified management team with the knowledge and experience to make the type of investments contemplated by the applicant’s business plan and SBA regulations. SBA has interpreted this section as requiring an SBIC to also maintain a qualified management team post-licensing, and has taken measures including suspending leverage draws when it determines that a qualified management team is not present. The proposed rule would make clear that a licensed SBIC (including an Early Stage SBIC) must have qualified management as long as it has a license.

*Section 107.1130—Leverage fees and additional charges payable by Licensee.* This section includes two changes to bring the regulation into conformity with statutory requirements. Current § 107.1130(d) provides for a 1 percent annual fee (“Charge”) that SBICs must pay on their outstanding SBA leverage, whether in the form of debentures or participating securities. However, section 303(b) of the Act (as amended by section 2(a)(1)(B) of P.L. 107–100, December 21, 2001) provides for the Charge on debentures to be adjusted annually as necessary to keep the debenture program at zero cost to taxpayers, and sets a maximum annual Charge of 1.38 percent. Section 303(g)(2) of the Act (as amended by section 117 of Pub. L. 108–84, September 30, 2003) provides for the Charge on participating securities to be similarly adjusted and sets a maximum annual Charge of 1.46 percent. Proposed § 107.1130(d)(1) and (d)(2) would conform to these two statutory provisions and to SBA’s actual practice in determining the annual Charge to be paid by SBICs.

Compliance With Executive Orders 12866, 12988 and 13132, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601–612)

#### Executive Order 12866

The Office of Management and Budget has determined that this rule is a “significant” regulatory action under Executive Order 12866. The Regulatory Impact Analysis is set forth below.

#### 1. Necessity of Regulation

The Small Business Investment Act of 1958 identifies the SBIC program’s mission as follows: “to stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply \* \* \*” Based on venture capital industry data (ThomsonOne VentureXpert), SBA believes that early stage businesses lack access to needed financing capital. Although the venture industry provided over \$22 billion in financings to U.S. businesses in calendar year 2010, this represented over a 23% decline from 2007. Less than a third of these financing dollars went to early stage or start-up businesses. Given the decline in venture capital financings over the past 3 years, SBA seeks to expand access to early stage businesses by implementing an initiative to provide up to \$1 billion in debenture leverage over five years (beginning in FY 2012) to a limited number of SBICs focused on early stage investments.

If SBA debenture leverage is to be used to finance early stage small businesses, the high risk associated with such investments indicates the need for more protections than those provided by the standard SBIC debenture and current regulations to mitigate risk and cost to the taxpayer. SBA is proposing regulatory changes to manage the risks associated with an early stage portfolio, including: (1) Limiting leverage for an individual Early Stage SBIC to 100 percent of Regulatory Capital or \$50 million, whichever is less; (2) establishing special distribution rules to require repayment of leverage whenever an Early Stage SBIC makes distributions to its investors; and (3) implementing risk monitoring actions appropriate to SBA’s leverage guarantor/creditor status. Even with these actions, in order to maintain an initial subsidy rate of zero for the debenture program while limiting the increase in leverage fees, SBA can only issue leverage to Early

Stage SBICs as a very small percentage of its portfolio.

## 2. Alternative Approaches to Regulation

SBA considered several alternatives to these proposed regulations. The first alternative was for SBA not to pursue the Early Stage initiative and continue with its current credit policy of not providing debenture leverage to SBICs that focus on early stage equity investing. SBA rejected this alternative because of the critical need for early-stage funding, particularly in the \$1 to \$5 million range that fits well with SBA's small business size standards.

SBA also considered seeking legislation for a new program specifically focused on investing in early stage small businesses. Although such an alternative could have provided an opportunity to introduce useful risk-management provisions, such as SBA profit sharing, SBA chose not to pursue this alternative because of the compelling need to begin assisting early stage small businesses as quickly as possible. A third alternative was for SBA to modify its credit policies to license and approve leverage to qualified early stage focused SBICs without changes in program regulations or in the terms of debenture leverage. SBA believes that doing so would not be financially responsible and would present an excessively high risk of losses to the taxpayer. Ultimately, SBA decided that it could responsibly license a limited number of early stage SBICs after implementing appropriate regulatory changes to manage the associated risk.

In proposing the definition for an Early Stage SBIC, SBA considered both the type of investment that should qualify as "early stage" and whether an Early Stage SBIC's portfolio should be limited to early stage investments exclusively. Many small businesses in the earliest stages of product development ("seed stage" companies) could benefit from access to additional capital. However, SBA chose not to limit the Early Stage initiative to seed stage investments because of their high risk and the long holding periods they typically require. Although Early Stage SBICs would not be prohibited from investing in seed stage companies, to use SBA debenture leverage successfully they will likely need to start generating cash returns on investments within 4 to 6 years after licensing. This timing concern is also why the proposed definition requires only 50 percent of an Early Stage SBIC's portfolio to be in early stage investments. This standard would allow Early Stage SBICs to make some later

stage investments that may produce current income or have shorter holding periods, thereby reducing the risk of default on SBA leverage.

In determining the maximum amount of leverage for which an Early Stage SBIC would be eligible, SBA decided that a one-to-one match between leverage and private capital (one "tier" of leverage) would provide the best balance between program cost and attractiveness to fund managers and investors. A second tier of leverage would result in a much higher projected loss rate, and a correspondingly greater increase in annual leverage fees for all debenture SBICs receiving new leverage commitments. SBA also considered a model in which SBA would have provided only half a tier of leverage. This lower ratio of leverage to private capital would have a much lower impact on leverage fees but would be unlikely to attract high quality fund managers and investors.

SBA also considered various dollar limits on the maximum leverage available to an Early Stage SBIC, in order to avoid an excessive concentration of risk in a small number of funds. A low dollar limit could allow more funds to be licensed, but could be unattractive to stronger applicants with the ability to raise and deploy larger amounts of capital. SBA believes the proposed limit of \$50 million is sufficient to attract high quality applicants. SBA also believes that \$50 million of leverage, in combination with at least \$50 million of private capital, is more than adequate to support a primarily early stage portfolio, with most financings expected to be in the \$1 to \$5 million range.

## 3. Potential Benefits and Costs

SBA anticipates that this proposed rule would provide significant benefit to early stage small businesses seeking investments by Early Stage SBICs. In estimating the impact, SBA considered that \$1 billion in anticipated leverage will be matched by a minimum of \$1 billion in private capital over the next 5 years, beginning in FY 2012. SBA expects that Early Stage SBICs will invest over a 5 to 7 year period after licensing. Allowing for payment of management expenses and interest, SBA estimates that the Early Stage initiative will result in approximately \$125 million annually in financings to small businesses over an 8 to 10 year period.

The proposed rule would impose additional cost in the form of increased annual fees on all debenture SBICs seeking new leverage commitments. The estimated cost has been incorporated into the program formulation model

which determines the annual fee needed to keep the debenture program's original subsidy cost at zero, as required by law. For FY 2012, SBA has budgeted \$150 million in leverage commitments to Early Stage SBICs, within the anticipated appropriated SBIC Debenture loan levels, representing approximately 7 percent of total expected debenture commitments. This 7 percent allocation would increase the annual fee on all new debenture commitments by approximately 13.7 basis points. This increase reflects the additional risk associated the early stage equity investments contemplated by the Early Stage initiative. Early stage investing is higher-risk than the typical SBIC portfolio, and would have required fees in excess of statutory caps, if operated on a stand-alone bases. To align fees and costs to the taxpayers with the overall policy goals, the Early Stage initiative incorporates terms designed to mitigate risk, and is limited to no more than \$200 million per fiscal year to keep the annual fees at reasonable levels. The cost is expected to vary each year based on the factors and assumptions used to develop the annual fee, including the total amount of debenture leverage commitments estimated, the amount committed to Early Stage SBICs, and interest rates.

### Executive Order 12988

This action meets applicable standards set forth in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or presumptive effect.

### Executive Order 13563

A description of the need for this regulatory action and benefits and costs associated with this action is included above in the Regulatory Impact Analysis under Executive Order 12866.

In connection with the launch of the President's "Start-Up America Initiative", SBA announced its commitment to making financing available to early stage small businesses through the SBIC program. In an effort to engage interested parties in this regulatory action, SBA has since made presentations at SBIC association meetings, Start-up America-related public events, and venture capital industry forums to discuss both the market need for new sources of early stage financing and key issues associated with the design of the Early Stage initiative. Participants were broadly supportive of using the SBIC program to expand the financing options available to early stage small

businesses, while adding key protective provisions to manage program risk.

Executive Order 13132

SBA has determined that this proposed rule will not have substantial, direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, for the purposes of Executive Order 13132, Federalism, SBA has determined that this proposed rule has no federalism implications warranting the preparation of a federalism assessment.

Paperwork Reduction Act, 44 U.S.C. Ch. 35

SBA has determined that this Early Stage SBIC proposed rule will not impose additional reporting or recordkeeping requirements. Early Stage SBIC applicants will submit the same license application form as other SBIC program applicants (OMB Control Number 3245-0062). Post-licensing, Early Stage SBICs will have the same recordkeeping and reporting requirements as any other licensed SBIC.

Regulatory Flexibility Act, 5 U.S.C. 601-612

When an agency promulgates a rule, the Regulatory Flexibility Act (5 U.S.C. 601-612) requires the agency to prepare an initial regulatory flexibility analysis (IRFA) describing the potential economic impact of the rule on small entities and alternatives that may minimize that impact. Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an IRFA, if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities. This proposed rule affects all SBICs issuing debentures, of which there are approximately 160, most of which are small entities. Therefore, SBA has determined that this proposed rule will have an impact on a substantial number of small entities. However, SBA has determined that the impact on entities affected by the rule will not be significant. SBA intends to maintain the SBIC program's initial subsidy cost to taxpayers at zero by charging up front and annual fees on its leverage. SBA calculates the annual fee each year using historical data to assess the appropriate fee to offset expected losses. The actual costs for SBIC guarantees may be higher or lower, and SBA will monitor program performance closely. Because SBA expects Early Stage SBICs to be riskier than standard SBICs, the

annual fees needed to keep the debenture program's original subsidy cost at zero are higher. For FY 2012, SBA estimates \$150 million leverage commitments to Early Stage SBICs, which increases the annual fee charged to all SBICs seeking new debenture commitments by approximately 13.7 basis points. Since annual leverage fees were introduced in FY 1998, the annual fee has ranged from a high of 100 basis points (1 percent) to a low of 29 basis points, with a 13-year median of 88 basis points. Although the cost will vary in the future based on economic factors and assumptions used to develop the annual fee, SBA expects the fee to remain under 1 percent, comparable to historical annual fees and below the statutory maximum of 1.38 percent. For debenture leverage committed and drawn by SBICs in FY 2012, SBA estimates that the sum of the debenture interest rate plus the annual fee will be in the vicinity of 5 percent. Debenture SBICs typically use the proceeds of debenture leverage to make loans to small businesses at interest rates in the 12 to 16 percent range, providing them with a significant spread over their cost of funds. Accordingly, the Administrator of the SBA hereby certifies that this rule will not have a significant impact on a substantial number of small entities. SBA welcomes comment from members of the public who believe there will be a significant impact either on SBICs, or on companies that receive funding from SBICs.

List of Subjects in 13 CFR Part 107

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

For the reasons stated in the preamble, SBA proposes to amend part 107 of title 13 of the Code of Federal Regulations as follows:

PART 107—SMALL BUSINESS INVESTMENT COMPANIES

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

Authority: 15 U.S.C. 681 et seq., 683, 687(c), 687b, 687d, 687g, 687m and Pub. L. 106-554, 114 Stat. 2763; and Pub. L. 111-5, 123 Stat. 115.

2. Amend § 107.50 by adding a definition of "Early Stage SBIC" and revising the definition of "Payment Date," to read as follows:

§ 107.50 Definitions of terms.

\* \* \* \* \*

Early Stage SBIC means a Section 301(c) Partnership Licensee, licensed

pursuant to § 107.310 of this part, in which at least 50 percent of all Loans and Investments (in dollars) must be made to Small Businesses that are "early stage" companies at the time of the Licensee's initial Financing. For the purposes of this definition, an "early stage" company is one that has never achieved positive cash flow from operations in any fiscal year.

\* \* \* \* \*

Payment Date means:

(1) For a Participating Securities issuer, each February 1, May 1, August 1, and November 1 during the term of a Participating Security, or

(2) For an Early Stage SBIC, each March 1, June 1, September 1, and December 1 during the term of a Debenture.

\* \* \* \* \*

3. Amend § 107.130 by revising the first sentence to read as follows:

§ 107.130 Requirement for qualified management.

When applying for a license, and while you have a license, you must show, to the satisfaction of SBA, that your current or proposed management team is qualified and has the knowledge, experience and capability necessary for investing in the types of businesses contemplated by the Act, the regulations in this part 107, and your business plan. \* \* \*

4. Amend § 107.210 by revising the paragraph subject heading and the first sentence of paragraph (a)(1) introductory text and adding paragraph (a)(3) to read as follows:

§ 107.210 Minimum capital requirements for Licensees.

(a) \* \* \*

(1) Licensees other than Participating Securities issuers and Early Stage SBICs. Except for Participating Securities issuers and Early Stage SBICs, a Licensee must have Regulatory Capital of at least \$5,000,000. \* \* \*

\* \* \* \* \*

(3) Early Stage SBICs. An Early Stage SBIC must have Regulatory Capital of at least \$20 million.

\* \* \* \* \*

5. Amend § 107.300 by revising the introductory text and adding paragraph (d) to read as follows:

§ 107.300 License application form and fee.

The license application must be submitted on SBA Form 2181 together with all applicable exhibits on SBA Form 2182 and a non-refundable processing fee computed as follows:

\* \* \* \* \*

(d) All applicants seeking to be licensed as Early Stage SBICs will pay the fee for a Partnership Licensee plus an additional \$10,000 fee, for a total of \$25,000.

6. Add § 107.305 to read as follows:

**§ 107.305 Evaluation of license applicants.**

SBA will evaluate a license applicant based on the submitted application materials, any interviews with the applicant's management team, and the results of background investigations, public record searches, and other due diligence conducted by SBA and other Federal agencies. SBA's evaluation will consider factors including the following:

(a) Management qualifications, including demonstrated investment skills and experience as a principal investor; business reputation; adherence to legal and ethical standards; record of active involvement in making and monitoring investments and assisting portfolio companies; successful history of working as a team; and experience in developing appropriate processes for evaluating investments and implementing best practices for investment firms.

(b) Performance of managers' prior investments, including investment returns measured both in percentage terms and in comparison to appropriate industry benchmarks; the extent to which investments have been realized as a result of sales, repayments, or other exit mechanisms; and the contribution of prior investments to the growth of portfolio company revenues and number of employees.

(c) Applicant's proposed investment strategy, including clarity of objectives; strength of management's rationale for pursuing the selected strategy; compliance with this part 107 and applicable provisions of part 121 of this chapter; fit with management's skills and experience; and the availability of

sufficient resources to carry out the proposed strategy.

(d) Applicant's proposed organizational structure and fund economics, including compliance with this part 107; soundness of financial projections and underlying assumptions; a compensation plan that provides managers with appropriate economic incentives; a reasonable basis for allocations of profits and fees to Persons not involved in management; and governance procedures that provide appropriate checks and balances.

7. Add § 107.310 to read as follows:

**§ 107.310 When and how to apply for licensing as an Early Stage SBIC.**

From time to time, SBA will publish a Notice in the **Federal Register**, inviting the submission of applications for licensing as an Early Stage SBIC. SBA will not consider an application from an Early Stage SBIC applicant that is under Common Control with another Early Stage SBIC applicant or an existing Early Stage SBIC (unless it has no outstanding Leverage or Leverage commitments and will not seek additional Leverage in the future). Applicants must comply with both the regulations in this part 107 and any requirements specified in the Notice, including submission deadlines. The Notice will specify procedures for a particular application period.

8. Add § 107.320 to read as follows:

**§ 107.320 Evaluation of Early Stage SBICs.**

SBA will evaluate an Early Stage SBIC license applicant based on the same factors applicable to other license applicants, as set forth in § 107.305, with particular emphasis on managers' skills and experience in evaluating and investing in early stage companies. In addition, SBA reserves the right to maintain diversification among Early Stage SBICs with respect to:

(a) The year in which they commence operations, and

(b) Their geographic location.

9. Add § 107.565 to read as follows:

**§ 107.565 Restrictions on third-party debt of Early Stage SBICs.**

If you are an Early Stage SBIC and you have outstanding Leverage or a Leverage commitment, you must get SBA's prior written approval to have, incur, or refinance any third-party debt other than accounts payable from routine business operations.

10. Amend § 107.585 by revising the first sentence to read as follows:

**§ 107.585 Voluntary decrease in Licensee's Regulatory Capital.**

You must obtain SBA's prior written approval to reduce your Regulatory Capital by more than two percent in any fiscal year, unless otherwise permitted under §§ 107.1560 and 107.1570, *provided however*, that if you are an Early Stage SBIC, you must obtain SBA's prior written approval for any reduction of your Regulatory Capital, including any reduction pursuant to a Distribution under § 107.1180 of this part. \* \* \*

11. Amend § 107.692 by redesignating paragraphs (c)(4) and (5) as paragraphs (c)(5) and (6), adding a new paragraph (c)(4), and revising the table in paragraph (d) to read as follows:

**§ 107.692 Examination fees.**

\* \* \* \* \*

(c) \* \* \*

(4) If you are an Early Stage SBIC with outstanding Leverage or Leverage commitments, you will pay an additional charge equal to 10% of your base fee;

\* \* \* \* \*

(d) \* \* \*

| Examination fee discounts | Amount of discount—% of base examination fee | Examination fee additions                      | Amount of addition—% of base examination fee |
|---------------------------|--|--|--|
| No prior violations ..... | 15   | Partnership or limited liability company ..... | 5  |
| Responsiveness .....      | 10   | Participating Security Licensee .....          | 10   |
|                           |  | Records/Files at multiple locations .....      | 10   |
|                           |  | Early Stage SBIC .....                         | 10   |

\* \* \* \* \*

12. Amend § 107.1120 by adding paragraph (k) to read as follows:

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

\* \* \* \* \*

(k) If you are an Early Stage SBIC, certify in writing that at least 50 percent of the aggregate dollar amount of your

Financings will be provided to "early stage" companies as defined under the definition of Early Stage SBIC in § 107.50 of this part.

13. Amend § 107.1130 by revising the first sentence of paragraph (d)(1) and the first sentence of paragraph (d)(2) to read as follows:

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

\* \* \* \* \*

(d) \* \* \*

(1) *Debentures*. You must pay to SBA a Charge, not to exceed 1.38 percent per annum, on the outstanding amount of your Debentures issued on or after October 1, 1996, payable under the same

terms and conditions as the interest on the Debentures. \* \* \*

(2) *Participating Securities.* You must pay to SBA a Charge, not to exceed 1.46 percent per annum, on the outstanding amount of your Participating Securities issued on or after October 1, 1996, payable under the same terms and conditions as the Prioritized Payments on the Participating Securities. \* \* \*

\* \* \* \* \*

14. Amend § 107.1150 by revising the first sentence of the introductory text and adding paragraph (d) to read as follows:

**§ 107.1150 Maximum amount of Leverage for a Section 301(c) Licensee.**

A Section 301(c) Licensee, other than an Early Stage SBIC, may have maximum outstanding Leverage as set forth in paragraphs (a) through (c) of this section. An Early Stage SBIC may have maximum outstanding Leverage as set forth in paragraph (d) of this section. \* \* \*

\* \* \* \* \*

(d) *Early Stage SBICs.* Subject to SBA's credit policies, if you are an Early Stage SBIC:

(1) The total amount of any and all Leverage commitments you receive from SBA shall not exceed 100 percent of your highest Regulatory Capital or \$50 million, whichever is less;

(2) On a cumulative basis, the total amount of Leverage you have issued shall not exceed the total amount of capital paid in by your investors; and

(3) The maximum amount of Leverage you may have outstanding at any time is the lesser of:

(i) 100 percent of your Leverageable Capital, or

(ii) \$50 million.

15. Amend Subpart I of Part 107 by adding an undesignated center heading and by adding new §§ 107.1180, 107.1181, and 107.1182 to read as follows:

**Subpart I—SBA Financial Assistance for Licenses (Leverage)**

\* \* \* \* \*

**Special Rules for Leverage Issued by an Early Stage SBIC**

**§ 107.1180 Required distributions to SBA by Early Stage SBICs.**

(a) *Distribution requirement.* If you are an Early Stage SBIC with outstanding Leverage, you may make Distributions to your investors and to SBA only as permitted under this § 107.1180. You may make a Distribution on any Payment Date. Unless SBA permits otherwise, you must notify SBA in writing of any

planned distribution under this section, including computations of the amounts distributable to SBA and your investors, at least 10 business days before the distribution date.

(b) *How SBA will apply Distributions.* Any amounts you distribute to SBA, or its designated agent or Trustee, under this § 107.1180 will be applied to repayment of principal of outstanding Debentures in order of issue. You may prepay any Debenture in whole, but not in part, on any Payment Date without penalty.

(c) *Condition for making a Distribution.* You may make a Distribution under this § 107.1180 only if you have paid all interest and Charges on your outstanding Debentures that are due and payable, or will pay such interest and Charges simultaneously with your Distribution.

(d) *SBA's share of Distribution.* For each proposed Distribution, determine SBA's share of the Distribution as follows:

(1) Determine the highest ratio of outstanding Leverage to Leverageable Capital that you have ever attained (your "Highest Leverage Ratio"). For the purpose of determining your Highest Leverage Ratio, any deferred interest Debentures issued at a discount must be included in the computation at their face value.

(2) Determine SBA's percentage share of cumulative Distributions:

(i) If your Capital Impairment Percentage under § 107.1840 is less than 50 percent as of the Distribution date, SBA's percentage share of cumulative Distributions equals:

$[\text{Highest Leverage Ratio}/(\text{Highest Leverage Ratio} + 1)] \times 100$

For example, if your Highest Leverage Ratio equals 1, then SBA's share of any distribution you make will be 50 percent.

(ii) If your Capital Impairment Percentage under § 107.1840 is 50 percent or greater as of the Distribution date, SBA's percentage share of cumulative Distributions equals 100 percent.

(3) Multiply the sum of all your prior Distributions and your current proposed Distribution (including Distributions to SBA, your limited partners and your General Partner) by SBA's percentage share of cumulative Distributions as determined in paragraph (d)(2) of this section.

(4) From the result in paragraph (d)(3) of this section, subtract the sum of all your prior Distributions to SBA under this § 107.1180.

(5) The amount of your Distribution to SBA will be the least of:

(i) The result in paragraph (d)(4) of this section;

(ii) Your current proposed Distribution; or

(iii) Your outstanding Leverage.

(e) *Additional Leverage prepayment.* On any Payment Date, subject to the terms of your Leverage, you may make a payment to SBA to be applied to repayment of the principal of one or more outstanding Debentures in order of issue, without making any Distribution to your investors.

**§ 107.1181 Interest reserve requirements for Early Stage SBICs.**

(a) *Reserve requirement.* If you are an Early Stage SBIC with outstanding Leverage, for each Debenture which requires periodic interest payments to SBA during the first five years of its term, you must maintain a reserve sufficient to pay the interest and Charges on such Debenture for the first 21 Payment Dates following the date of issuance. This reserve may consist of any combination of the following:

(1) Binding unfunded commitments from your Institutional Investors that cannot be called for any purpose other than the payment of interest and Charges to SBA, or the payment of any amounts due to SBA; and

(2) Cash maintained in a separate bank account or separate investment account permitted under § 107.530 of this part and separately identified in your financial statements as "restricted cash" available only for the purpose of paying interest and Charges to SBA, or for the payment of any amounts due to SBA.

(b) Your limited partnership agreement must incorporate the reserve requirement in paragraph (a) of this section.

**§ 107.1182 Valuation requirements for Early Stage SBICs based on Capital Impairment Percentage.**

(a) If you are an Early Stage SBIC, you must compute your Capital Impairment Percentage and determine whether you have a condition of Capital Impairment in accordance with §§ 107.1830 and 107.1840 of this part.

(b) You must promptly notify SBA in writing if your Capital Impairment Percentage is at least 50 percent, even if your maximum permitted Capital Impairment Percentage is higher.

(c) Upon receipt of your notification under paragraph (b) of this section, or upon making its own determination that your Capital Impairment Percentage is at least 50 percent, SBA has the right to require you to engage, at your expense, an independent third party, acceptable to SBA, to prepare valuations of some or

all of your Loans and Investments, as designated by SBA.

16. Amend § 107.1810 by revising paragraphs (f)(2)(ii) and (iii) and adding paragraphs (f)(2)(iv), (f)(11), (f)(12), and (j) to read as follows:

**§ 107.1810 Events of default and SBA's remedies for Licensee's noncompliance with terms of Debentures.**

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

(ii) Payments from Retained Earnings Available for Distribution based on either the shareholders' prorata interests or the provisions for profit distributions in your partnership agreement, as appropriate;

(iii) Distributions by Participating Securities issuers as permitted under §§ 107.1540 through 107.1580; and

(iv) Distributions by Early Stage SBICs as permitted under § 107.1180.

\* \* \* \* \*

(11) *Failure by an Early Stage SBIC to meet investment requirements.* You are an Early Stage SBIC and, beginning on the first fiscal quarter end when your cumulative total Financings (in dollars) are at least equal to your Regulatory Capital, you have not made at least 50 percent of such Financings to Small Businesses that at the time of your initial Financing were "early stage" companies, as defined under the definition of Early Stage SBIC in § 107.50 of this part.

(12) *Failure by an Early Stage SBIC to maintain required interest reserve.* You are an Early Stage SBIC and you fail to maintain a sufficient reserve to pay interest and Charges on your Debentures as required under § 107.1181 of this part.

\* \* \* \* \*

(j) *Additional SBA remedies applicable to Debentures issued by Early Stage SBICs.*

If you are an Early Stage SBIC, upon SBA's payment pursuant to its guarantee of any of your Debentures, SBA shall have the following additional rights and you consent to SBA's exercise of any or all of such rights:

(1) To prohibit you from making any additional investments except for investments under legally binding commitments you entered into before such payment by SBA and, subject to SBA's prior written approval, investments that are necessary to protect your investments;

(2) Until all Leverage is repaid and amounts related thereto are paid in full, to prohibit Distributions by you to any party other than SBA, its agent or Trustee;

(3) To require all your commitments from investors to be funded at the earliest time(s) permitted in accordance with your Articles;

(4) To review and re-determine your approved Management Expenses; and

(5) To the appointment of SBA or its designee as your receiver under section 311(c) of the Act for the purpose of continuing your operations.

Dated: December 6, 2011.

**Karen G. Mills,**

*Administrator.*

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**BILLING CODE 8025-01-P**

**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

**24 CFR Parts 91, 576, 580, and 583**

**[Docket No. FR-5475-P-01]**

**Homeless Management Information Systems Requirements**

**AGENCY:** Office of the Assistant Secretary for Community Planning and Development.

**ACTION:** Proposed rule.

**SUMMARY:** This proposed rule provides for the establishment of regulations for Homeless Management Information Systems (HMIS), which are the local information technology systems that HUD recipients and subrecipients use for homeless assistance programs authorized by the McKinney-Vento Homeless Assistance Act (the McKinney-Vento Act). The Homeless Emergency Assistance and Rapid Transition to Housing Act of 2009 (HEARTH Act), enacted into law on May 20, 2009, in addition to consolidating and amending programs authorized by the McKinney-Vento Act, codifies in law the Continuum of Care planning process, as well as certain data collection requirements integral to HMIS. The HEARTH Act requires that HUD ensure operation of and consistent participation by recipients and subrecipients in HMIS. While Continuums of Care have been using HMIS for several years, this proposed rule would add a new part to the Code of Federal Regulations to regulate the administration of HMIS and collection of data using HMIS, as provided for by the HEARTH Act. In addition, this proposed rule would make corresponding changes to HUD's regulations for Consolidated Submissions for Community Planning and Development Programs, at 24 CFR part 91; the Emergency Solutions Grants program, at 24 CFR part 576; the Shelter

Plus Care Program, at 24 CFR part 582; and the Supportive Housing Program, at 24 CFR part 583.

**DATES:** *Comment Due Date.* February 7, 2012.

**ADDRESSES:** Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, 451 7th Street, SW., Room 10276, Department of Housing and Urban Development, Washington, DC 20410-0500.

Communications must refer to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

1. *Submission of Comments by Mail.* Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410-0500.

2. *Electronic Submission of Comments.* Interested persons may submit comments electronically through the Federal eRulemaking Portal at <http://www.regulations.gov>. HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit comments, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the <http://www.regulations.gov> Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

**Note:** To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.

*No Facsimile Comments.* Facsimile (FAX) comments are not acceptable.

*Public Inspection of Public Comments.* All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m., eastern time, weekdays at the above address. Due to security measures at the HUD Headquarters building, an advance appointment to review the public comments must be scheduled by calling the Regulations Division at (202) 708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number through TTY by calling the Federal Information Relay Service at (800) 877-