# Proposed Rules

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

## SMALL BUSINESS ADMINISTRATION

## 13 CFR Part 107

## Small Business Investment Companies

**AGENCY:** Small Business Administration.

**ACTION:** Proposed rule.

**SUMMARY:** This proposed rule would modify the management-ownership diversity requirement in SBA's Small Business Investment Company (''SBIC'') Program to prohibit the ownership of more than 70% of a leveraged SBIC by any single investor or group of affiliated investors. This action will help to ensure that each new leveraged SBIC has managers that exercise independence in managing the operations of the SBIC.

**DATES:** Submit comments on or before September 13, 2000.

**ADDRESSES:** Address comments to Leonard Fagan, Investment Division, U.S. Small Business Administration, 409 3rd Street, SW., Suite 6300, Washington, DC 20416.

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

**SUPPLEMENTARY INFORMATION:** In 1994, SBA adopted a regulation requiring that all small business investment companies (''SBICs'') intending to issue participating securities have independence, or ''diversity'', between the management and the ownership of the company. 59 FR 16918 (April 8, 1994). This requirement of independence was designed to prevent the types of abuses that SBA had observed in SBICs owned and operated by a single individual or group of individuals. The abuses, which included conflict of interest transactions, misapplication of funds, and other types of self-dealing activities, had resulted in significant losses to SBA.

To satisfy the 1994 management-ownership diversity regulation, at least 30% of the capital of the SBIC had to be owned by investors who were neither Associates nor Affiliates of any Associates of the SBIC (as such terms were defined in 13 CFR parts 107 and 121). In other words, at least 30% of the capital of the SBIC had to be owned by investors who were not part of the SBIC's management team and did not control the SBIC's management team. In general, three such ''diversity investors'' were required, but a single diversity investor would suffice if the investor was an entity that met certain net worth and regulatory oversight requirements.

The 1994 regulation permitted an SBIC with a parent company (i.e., an investor owning greater than 50% of the SBIC) to treat the parent company's investors as if they were direct investors in the SBIC for purposes of demonstrating diversity. SBA would, in effect, ''look-through'' to the investors in the parent company for the desired independence from, and oversight of, the management of the SBIC.

In 1996, SBA extended the management-ownership diversity requirement to all new SBICs intending to use SBA financial assistance, or ''leverage'', whether the leverage was in the form of participating securities or debentures. 61 FR 3177 (January 31, 1996). SBA also replaced the automatic look-through provision described above with a discretionary look-through: SBA, in the exercise of its discretion, could look through to the parent's investors, but such treatment was no longer automatic. This change was in response to the increasing complexity SBA was encountering in ''drop-down'' SBICs (SBIC subsidiaries of larger companies), where the combination of multi-tiered organizational structures and other factors had led SBA to conclude that the necessary oversight by independent owners might not be present. SBA could still look through to the parent company's investors to find diversity, but would do so only if SBA believed that the result was consistent with the intent of the diversity regulation.

Later in 1996, Congress expressed its support for management-ownership diversity by enacting a statutory provision requiring SBA to ensure that the management of all new SBICs ''is sufficiently diversified from and unaffiliated with the ownership of the licensee in a manner that ensures independence and objectivity in the financial management and oversight of the investments and operations of the licensee.'' 15 U.S.C. 682(c); Pub. L. 104–208, § 208(c)(3) (September 30, 1996). SBA subsequently made minor changes to strengthen the management-ownership diversity regulation. These changes included requiring (1) that the diversity investors be unrelated to each other, (2) that each diversity investor have a significant ownership interest in dollar and percentage terms, and (3) that an SBIC's diversity be evidenced in its paid-in capital, not just its unfunded commitments. 63 FR 5859 (February 5, 1998).

SBA believes that, overall, the management-ownership diversity regulation has been successful in encouraging the presence of investors who are truly independent of management. However, SBA has had concerns with whether independence is assured when a single investor, unrelated to the management team, owns substantially all of an SBIC.

Under the current regulation, to provide diversity the non-management interest is required to be at least 30% of the SBIC, but could be as much as 100% and could be owned by a single entity. This single super-majority investor can provide the required diversity from management as long as the investor does not control, is not controlled by, and is not under common control with, the managers of the SBIC. Thus, for diversity to be provided by a single super-majority investor who is otherwise unrelated to the SBIC's management team, SBA must conclude that the investor does not control the SBIC's managers by virtue of the size of the investor's ownership interest in the SBIC.

In that regard, SBA believes that the degree of influence that can be exerted by a super-majority investor may significantly reduce the management team's ability to act independently and objectively. The larger the size of an investor's ownership interest, the greater the investor's potential influence over the activities of the SBIC. This is true even if the investor is a passive limited partner.

At some ownership level, an investor's power to influence effectively becomes the power to control the managers of the SBIC, and the management team can no longer be said to have the ability to act independently. SBA's experience in administering the existing management-ownership diversity regulation has persuaded it

that it is difficult to objectively establish when that ownership level is reached. However, if the super-majority investor is limited to owning not more than 70%, and there is a 30% diversity investor that is independent of both the management and the super-majority investor, the super-majority investor's degree of potential influence on management becomes acceptable.

Accordingly, SBA proposes to amend the management-ownership diversity regulation, section 107.150, to prohibit ownership of more than 70% of a leveraged SBIC by a single investor or group of affiliated investors.

SBA recognizes that there may be categories of investors who can be permitted to own in excess of 70% of an SBIC without destroying the SBIC's management-ownership diversity. SBA believes that one such category is the traditional investment company—a professionally managed firm organized exclusively to pool capital from more than one source for the purpose of investing in businesses that are expected to generate substantial returns to the firm's investors.

A subsidiary SBIC of such a traditional investment company can offer meaningful management-ownership diversity even if the investment company owns substantially all of the SBIC. This is true for a number of reasons. First, a traditional investment company has managers who are largely unrelated to and unaffiliated with the investors in the firm. These independent managers typically also serve as the managers of the subsidiary SBIC. Second, the managers of a traditional investment company and its subsidiary SBIC are properly authorized and motivated to make investments that, in their independent judgment, are likely to produce significant returns to all investors in the investment company and in the SBIC. Although the managers act independently of the investors in the firm, they are directly accountable to them. Most importantly, a traditional investment company benefits from the use of a subsidiary SBIC only if the SBIC makes profitable investments.

SBICs with other types of super-majority investors do not necessarily present the same degree of management independence and objectivity, plus investor oversight. The objectives of other super-majority investors may include something other than profit maximization at the SBIC level. Large operating companies, for example, may profit from the use of a subsidiary SBIC other than through the financial performance of the SBIC. The SBIC might make strategic investments to support or otherwise benefit the non-investing activities of the operating company, rather than investments intended solely to contribute to the profitability of the SBIC. This would defeat one of the underlying purposes of management-ownership diversity—the protection of SBA's financial interest in the SBIC.

The proposed rule would permit a traditional investment company to own and control more than 70% of an SBIC. SBA welcomes comments and suggestions as to whether a similar exception should be provided for other types of investors in an SBIC.

The 30% test in the current diversity regulation would continue to be required under the proposed regulation, but with slight modifications. First, current paragraph (a)(2), which treats publicly-traded licensees as automatically satisfying the 30% test, would be eliminated. SBA expects that the small number of license applicants intending to be public companies should easily be able to demonstrate their compliance with the 30% test.

Second, the proposed rule would add two new categories to the list of entities currently permitted to serve as the sole (30%) diversity investor in an SBIC, and would clarify one of the existing categories. The current list includes, in paragraph (a)(1)(i), entities that are subject to some satisfactory form of government oversight or regulation. The proposed rule clarifies that this category is intended to capture only those entities whose overall activities are both regulated and periodically examined by a satisfactory governmental authority. U.S. federal and state bank regulators or insurance commissions are examples of satisfactory governmental authorities for this purpose. Regulation of an entity's health and safety activities by the Office of Safety and Health Administration (OSHA), on the other hand, would not be acceptable for this purpose.

The two new categories of entities to be added to paragraph (a)(1) by the proposed rule would cover any Institutional Investor that (1) is listed on the New York Stock Exchange or (2) is publicly-traded and meets the minimum numerical and corporate governance listing standards of that Exchange. Companies satisfying either of these listing standards have sufficient size and public oversight and visibility to justify treating them the same as regulated companies for purposes of the diversity regulation. SBA expects this proposed change to resolve any uncertainty as to the requirements for a publicly-traded company to be considered acceptable to SBA as a single diversity investor under the regulation.

The proposed management-ownership diversity regulation would apply to an existing SBIC only if SBA requires management-ownership diversity as a condition of SBA's approval of the licensee's change of control or if a non-leveraged SBIC wants to be approved as eligible to issue leverage. SBA is proposing to amend section 107.440(c) to clarify that SBA's approval of a change of control of an SBIC may be conditioned upon the licensee's compliance with the diversity regulation, as well as minimum capital requirements, then in effect. This has been SBA's practice since the diversity regulation was first adopted.

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

This proposed rule is a significant regulatory action for purposes of Executive Order 12866 and was reviewed by the Office of Management and Budget.

SBA has determined that this proposed rule would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601–612. The purpose of the proposed rule is to redefine and clarify the concept of management-ownership diversity in an SBIC. The proposed rule would not apply to the approximately 365 companies currently licensed as SBICs, except in the insignificant number of cases where a transfer of control of the licensee occurs or where an SBIC that was not licensed with the expectation that it would issue leverage applies for such approval.

For purposes of Executive Order 12988, SBA has determined that this proposed rule is drafted, to the extent practicable, in accordance with the standards set forth in Section 3 of that Order.

For purposes of Executive Order 13132, SBA has determined that this proposed would have no federalism implications.

For purposes of the Paperwork Reduction Act, 44 U.S.C. Ch. 35, SBA has determined that this proposed rule, if adopted in final form, would contain no new reporting or recordkeeping requirements.

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

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

For the reasons stated above, the SBA proposes to amend 13 CFR part 107 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), 6887b, 687d, 687g and 687m.

2. Revise § 107.150 to read as follows:

### § 107.150 Management and ownership diversity requirement.

You must have diversity between your management and your ownership

(1) In order to obtain an SBIC license (unless you do not plan to obtain Leverage),

(2) If at the time you were licensed you did not plan to obtain Leverage, but you now wish to be eligible for Leverage, or

(3) If SBA requires it as a condition of approval of your transfer of Control under § 107.440. To establish diversity you must meet the requirements in paragraphs (a) and (b) of this section, and you must maintain voting rights and diversity in accordance with paragraphs (c) and (d) of this section.

(a) *Percentage ownership requirement.* (1) Except as provided in paragraph (a)(2) of this section, no Person or group of Persons who are Affiliates of one another may own or control, directly or indirectly, more than 70 percent of your Regulatory Capital or your Leverageable Capital.

(2) *Exception.* An investor that is a traditional investment company, as determined by SBA, may own and control more than 70 percent of your Regulatory Capital and your Leverageable Capital. For purposes of this section, a traditional investment company must be a professionally managed firm organized exclusively to pool capital from more than one source for the purpose of investing in businesses that are expected to generate substantial returns to the firm's investors. In determining whether a firm is a traditional investment company for purposes of this section, SBA will also consider:

(i) Whether the managers of the firm are unrelated to and unaffiliated with the investors in the firm;

(ii) Whether the managers of the firm are authorized and motivated to make investments that, in their independent judgment, are likely to produce significant returns to all investors in the firm;

(iii) Whether the firm benefits from the use of the SBIC only through the financial performance of the SBIC; and

(iv) Other related factors.

(b) *Non-affiliation requirement.*—(1) *General rule.* At least 30 percent of your Regulatory Capital and Leverageable Capital must be owned and controlled by three Persons unaffiliated with your management and unaffiliated with each other, and whose investments are significant in dollar and percentage terms as determined by SBA. Such Persons must not be your Associates (except for their status as your shareholders, limited partners, or members) and must not Control, be Controlled by, or be under Common Control with any of your Associates. A single ''acceptable'' Institutional Investor may be substituted for two or three of the three Persons who are otherwise required under this paragraph. The following Institutional Investors are ''acceptable'' for this purpose:

(i) Entities whose overall activities are regulated and periodically examined by state, Federal, or other governmental authorities satisfactory to SBA;

(ii) Entities listed on the New York Stock Exchange;

(iii) Entities that are publicly-traded and that meet both the minimum numerical listing standards and the corporate governance listing standards of the New York Stock Exchange;

(iv) Public or private employee pension funds;

(v) Trusts, foundations, or endowments, but only if exempt from Federal income taxation; and

(vi) Other Institutional Investors satisfactory to SBA.

(2) *Look-through for traditional investment company investors.* SBA, in its sole discretion, may consider the requirement in paragraph (b)(1) of this section to be satisfied if at least 30 percent of your Regulatory Capital and Leverageable Capital is owned and controlled indirectly, through a traditional investment company, by Persons unaffiliated with your management.

(c) *Voting requirement.* (1) Except as provided in paragraph (c)(2) of this section, the investors required for you to satisfy diversity may not delegate their voting rights to any Person who is your Associate, or who Controls, is Controlled by, or is under Common Control with any of your Associates, without prior SBA approval.

(2) *Exception.* Paragraph (c)(1) of this section does not apply to investors in publicly-traded Licensees, to proxies given to vote in accordance with specific instructions for single specified meetings, or to any delegation of voting rights to a Person who is neither a diversity investor in the Licensee nor affiliated with management of the Licensee.

(d) *Requirement to maintain diversity.* If you were required to have management-ownership diversity at any time, you must maintain such diversity while you have outstanding Leverage or Earmarked Assets. To maintain management-ownership diversity, you may continue to satisfy the diversity requirement as in effect at the time it was first applicable to you or you may satisfy the management-ownership diversity requirement as currently in effect. If, at any time, you no longer have the required management-ownership diversity, you must:

(1) Notify SBA within 10 days; and

(2) Re-establish diversity within six months. For the consequences of failure to re-establish diversity, see §§ 107.1810(g) and 107.1820(f).

3. In § 107.440, revise paragraph (c) to read as follows:

### § 107.440 Standards governing prior SBA approval for a proposed transfer of Control.

* * * * *

(c) Require compliance with any other conditions set by SBA, including compliance with the requirements for minimum capital and management-ownership diversity as in effect at such time for new license applicants.

Dated: August 7, 2000.

**Fred P. Hochberg,**

*Acting Administrator.*

[FR Doc. 00–20477 Filed 8–11–00; 8:45 am]

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## DEPARTMENT OF TRANSPORTATION

## Federal Aviation Administration

## 14 CFR Part 23

**[Docket No. CE162; Notice No. 23–00–03–SC]**

## Special Conditions: Ayres Corporation, Model LM 200, ''Loadmaster''; Propulsion

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Notice of proposed special conditions.

**SUMMARY:** This document proposes special conditions for the Ayres Corporation, Model LM 200 airplane. This airplane will have a novel or unusual design feature associated with a 14 CFR part 23 commuter category airplane incorporating a propulsion system that consists of two turboshaft engines driving a single propeller through a combining gearbox. The