SMALL BUSINESS ADMINISTRATION

13 CFR Part 120

RIN 3245–AE41

Development Company Loan (504) Program Changes

AGENCY: U.S. Small Business Administration (SBA).

ACTION: Final rule.

SUMMARY: The U.S. Small Business Administration (''SBA'' or ''the Agency'') is amending the Certified Development Company (''CDC'') Loan Program (the ''CDC Program'' or the ''504 Program'') in order to improve delivery of the 504 Program to small businesses. The most significant regulations changed are those governing a CDC's area of operations; a CDC's organizational structure; the requirements for a new CDC or a CDC requesting to expand its territory; the ''adequately served'' standard; and whether a CDC may participate in other SBA loan programs. Also, to allow for greater delegation of authority to CDCs, the rule includes expanded sections on the Accredited Lender Program (''ALP''), the Premier Certified Lender Program (''PCLP'') and a simplification and clarification of the enforcement provisions for CDCs. The amendments also clarify the regulations governing fees that a small business may and may not be charged.

DATES: This rule is effective November 6, 2003.

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SUPPLEMENTARY INFORMATION:

Rulemaking History

On July 8, 2003, SBA published in the **Federal Register** a proposed rule (68 FR 40553). The proposed rule took into consideration and was based in part on over 1,900 comments SBA received in response to an Advanced Notice of Proposed Rulemaking (''ANPRM'') published in the **Federal Register** by SBA on December 6, 2002. SBA received over 70 comments in response to the proposed rule.

Statutory Basis of the 504 Program

The 504 Program, Title V of the Small Business Investment Act (''Act''), 15 U.S.C. 695, was established by Public Law 85–699 on August 21, 1958. A ''development company'' was defined as an enterprise formed for the purpose of furthering economic development of its community and environs, and with authority to promote and assist the growth and development of small business concerns in the areas covered by their operations. The law further stated that a local development company is a corporation chartered under any applicable State corporation law to operate in a specified area within a State and be composed of, and controlled by, persons residing or doing business in the locality. The program was amended in 1980 due to changing business conditions for small businesses. During the late 1970s and early 1980s, the prime interest rate and unemployment rate reached historically high levels. It was generally believed that long-term, fixed-rate money was not available at a reasonable cost to small businesses because of these high prevailing rates and that this was hindering job creation. Congress enacted section 503 of the Act in 1980. The 503 and 504 Programs were intended to provide long-term, fixed-rate financing to small businesses at favorable terms that were unavailable in the commercial marketplace. Congress specified in the Act that this program ''foster economic development and create or preserve job opportunities in both urban and rural areas by providing long-term financing for small business concerns * * *'' The statute authorizes SBA to guarantee debentures backing long-term, fixed-asset loans (''504 Loans'') made by CDCs. It also authorizes SBA to pool the guarantees and sell interests in the pools to investors.

Overview of the Changes to the 504 Regulations

SBA believes the regulatory changes will improve 504 Program delivery to small business customers by increasing customer choice of service; increase third-party lender choice of CDCs; facilitate the formation of new CDCs; facilitate the expansion of existing CDCs; and increase the number of CDCs able to take advantage of special initiatives for rural areas. By allowing market-driven forces to determine availability of 504 Program service, small businesses will have greater opportunity to negotiate the best total financing package including fees, as well as receive increased service by CDCs. In addition, the 504 Program will be more responsive to changes in market conditions.

To allow for greater delegation of authority to CDCs, this final rule includes expanded sections on the ALP and the PCLP. This final rule also simplifies and clarifies the enforcement provisions for CDCs. In addition, SBA is amending the regulations governing ''job opportunity average'' to permit more flexibility to adjust the average in response to increased costs as reflected by such measures as the consumer price index. This change will permit CDCs to approve more projects that do not meet the job creation criteria but do meet other statutory goals such as increasing manufacturers' productivity and competitiveness through re-tooling, robotics or modernization. The final rule also clarifies the regulations governing fees that a small business may and may not be charged. The regulations covered by the final rule are 13 CFR, Subpart A, § 120.102 and § 120.140, and Subpart H, §§ 120.800 through 120.984.

The 504 Program from 1986 to 2002 has created or retained more than 1.5 million jobs, averaging approximately $13,600 of debenture per job. However, the 504 Program has not used all of its available budgetary authority for many years. The 504 Program's authorization level for fiscal year 2002, for example, was $4.5 billion compared to the total approval level of $2.5 billion.

SBA has decided to take steps to increase the availability of the long-term, fixed-rate financing offered by the 504 Program that is vital for our nation's small business community. This final rule begins this process by establishing the State in which a CDC is incorporated as the CDC's minimum area of operations. Currently, each CDC is assigned a specific, local area, typically several counties. Only one CDC per State is permitted to be a statewide CDC. In some cases, there are geographic areas that do not have CDC coverage. Although CDCs' areas of operations often overlap, SBA believes that establishing statewide areas of operations for all CDCs will increase the availability of 504 Program assistance to small businesses. SBA also believes that it is empowering the CDCs' boards to determine what is the optimal area of operations within the State for the CDC to market and service effectively.

Next, SBA is eliminating the ''adequately served'' standard. Currently, a county meets the standard of ''adequately served'' when the CDC that includes the county in its area of operations averages at least one 504 loan approval in that county per 100,000 population per year averaged over two years. In such cases, the county is unavailable both to an existing CDC applying to expand its operations to include that county and to a new CDC applying to include that county in its proposed area of operations. In addition, the regulations currently do not permit a new CDC, or a CDC applying to expand its area of operations, to apply for a particular county if that county has become part of another CDC's area of

operations within the previous 24 months. Eliminating this standard will encourage new CDC applications and existing CDCs to expand their operations within their state of incorporation without first having to go through a lengthy expansion application process. SBA is allowing the marketplace to determine the maximum number of CDCs that can co-exist within a State. With these changes SBA anticipates that small businesses, as well as lenders, will have greater choice in, and access to, capital.

To facilitate these changes, SBA is streamlining CDC organizational structure by modifying the CDCs' general membership requirements. Currently, a CDC is required to have a general membership that covers the CDC's entire area of operations. In the final rule, SBA will no longer require that a CDC's membership cover the entire area of operations, but rather will require that the CDC's members each actively support economic development within all or some portion of the CDC's area of operations. The CDC's board of directors would make the decision on how widely disbursed the CDC's general membership needs to be to meet the objective of local economic development. The result of this change and others will be that CDCs will be empowered to determine in which areas within their state of incorporation they wish to engage in 504 Program activities; they will not be required to serve the entire state but may do so if they choose. SBA also is modifying the regulations governing contracting for staff to facilitate a CDC's contracting for ''back office'' work with a contractor located outside of the CDC's area of operations. SBA believes that this will permit certain economies of scale by providing additional sources of expertise in 504 packaging, processing, servicing and liquidation.

For CDCs that apply to cross State lines as a multi-state CDC, the CDC also will be able to determine the geographic coverage of its general membership in the new State. Also for multi-state CDCs, SBA is relaxing the requirements for board representation from the new State by eliminating the current requirement that at least three of the CDC's board members must come from the new State. In addition, SBA is allowing a CDC that currently has ALP or PCLP authority in its State of incorporation to use that authority in its expanded area. To ensure that only those CDCs with demonstrated proficiency in the 504 Program are permitted to expand beyond their State of incorporation, SBA is requiring applicants for multi-state CDC and local economic area expansion to be ALP-qualified, among other things. Taken together, SBA believes that these changes in a CDC's area of operations, elimination of the concept of ''adequately served,'' elimination of the requirement that a CDC's membership cover the entire area of operations, the clarification of contracting requirements, and the changes in the expansion requirements for CDCs will result in the 504 Program becoming more relevant in today's dynamic financial services marketplace.

The final rule prohibits a CDC from investing in or being affiliated with a 7(a) lender. This rule was developed after reviewing the comments on this issue received in response to the ANPRM. The majority of those commenting on this issue, as well as those that commented on the proposed rule, stated that the 504 Program should remain separate from the 7(a) Program.

The concept of permitting a CDC to invest in a Small Business Investment Company (''SBIC'') generally was supported by the commenters to the ANPRM. Many writers viewed such an investment as economic development as long as the SBIC and the CDC were not affiliates. However, SBA's current regulations prohibit a CDC from owning an equity interest in a business that has received or is applying to receive SBA financing (§ 120.140). Since SBICs typically have an ownership interest in the businesses that they assist, a CDC that has invested in an SBIC also would have an ownership interest in the small business receiving financing from the SBIC and could potentially violate this regulation by providing financing directly to that small business. In addition, SBA's regulations state that a CDC must operate in its area of operations. SBA interprets this requirement to apply to all CDC activities that use funds generated from the 504 Program. In light of these concerns, at this time, SBA is prohibiting a CDC from investing in an SBIC.

Section-by-Section Analysis

SBA is adding a definition of ''SOP'' to § 120.102, the definitions section applicable to the entire part 120. SBA's SOPs are available at any SBA office (see 13 CFR 102.2 and are generally available in SBA's reading room on its Web site (*http://www.SBA.GOV*).

SBA is amending § 120.140 to delete references to Associate Development Companies (''ADC'') (see discussion of § 120.850).

SBA is changing the headings for § 120.800 and § 120.801 to make them consistent with the other section headings in Subpart H.

In § 120.802 the definition of ''Area of Operations'' is modified to define the minimum area of operations for a CDC as the State in which the CDC is incorporated. As stated in the proposed rule, SBA has decided to take steps to increase the availability of the long-term, fixed-rate financing offered by the 504 Program that is vital for our nation's small business community. Currently, each CDC is assigned a specific, local area, typically several counties. Only one CDC per State is permitted to be a statewide CDC. In some cases, there are geographic areas that do not have CDC coverage. Although CDCs' areas of operations often overlap, SBA believes that establishing statewide areas of operations for all CDCs will increase the availability of 504 Program assistance to small businesses. Most of the comments SBA received concerned the proposed change to the CDC's minimum area of operations. Several comments were opposed to the proposed change based on concerns that the changes would dilute a CDC's role in community and economic development as well as a concern that rural areas would be neglected. Some commenters also were concerned that a CDC could not provide adequate servicing to much larger geographic areas. SBA also received several comments supporting the change as proposed. One such comment explained that it would eliminate monopolies that some CDCs currently have. Another stated that competition will result in the CDC working harder to distinguish itself by attempting to provide better service at the lowest possible cost. Other commenters supported expansion of a CDC's minimum area of operations but wanted the SBA district offices' geographic jurisdiction to define the minimum area, not the State.

With regard to the concern about whether CDCs will be able to adequately provide 504 Program service to the much larger geographic area of the State in which it is incorporated, SBA did not propose to require that a CDC must serve the entire State in which it is incorporated when it proposed to change the ''area of operations'' definition to provide for a minimum of the State in which the CDC is incorporated. A CDC will continue to be free to concentrate its 504 Program activities in whatever portions of its State it believes it can operate effectively as a CDC.

As to the issue of the specific geographic limit of the area of operations (*i.e.*, Statewide, as proposed; district-wide, as favored by several

commenters; or some even smaller geographic area), SBA is implementing the Statewide minimum. First, SBA does not believe that this necessarily will result in rural areas being neglected, as several commenters suggested. Under the current regulations many such areas are being neglected now, and SBA believes that increased competition among CDCs within a State may result in bringing additional access to capital to those areas, as CDCs focus their efforts on places where they have a competitive advantage.

SBA also does not believe that changing the minimum area of operations to statewide necessarily will result in a dilution of a CDC's role in community and economic development. A CDC will have the discretion to determine over what geographic areas within its State it has the ability, based on its membership, board, and staff, to provide economic development. Local economic development remains one of the goals of projects financed by 504 loans, pursuant to section 502(d)(2) of the Act and § 120.862(a). However, SBA does not believe that a CDC necessarily must operate only in a small geographic area in order to meet the local economic development needs of that area. In addition, the purpose of the 504 Program is not only to foster local economic development, but to meet other goals, such as the public policy goals listed in section 501(d)(3) of the Act and § 120.862(b) which are not dependent on a CDC having a local presence, are even less dependent on a CDC having a local presence.

While SBA agrees that the Agency could introduce competition to the 504 Program within smaller geographic areas than a State, the Statewide minimum will allow SBA to administer the 504 Program more efficiently, given its increasingly limited staff resources. A district-wide minimum area of operations standard would produce a double standard between the 43 States in which all CDCs would be Statewide, by virtue of the fact that there is only one district office in each of those States, and the remaining seven States with multiple districts, which would require additional monitoring by SBA. An even smaller geographic area of operations standard would require an even greater expenditure of SBA's resources to oversee and administer. For these reasons, the final rule publishes the area of operations definition in § 120.802 as proposed.

The definition of ''Local Economic Area'' also is revised slightly to make it consistent with the revised, statewide ''Area of Operations'' definition. SBA received several comments that suggested confusion on the part of the commenters in interpreting what was being changed in the definition. SBA had proposed changes only to the first sentence of the definition. Specifically, SBA did not propose to delete the reference to a ''metropolitan statistical area'' as an example of a local economic area and, therefore, that reference will continue to be part of the regulation.

SBA received several comments that suggested that SBA did not adequately address whether the revised definition of area of operations would mean that local economic areas adjacent to a CDC's State of incorporation would be included in a CDC's minimum area of operations. SBA did not propose a change to the concept of a local economic area, and the proposed rule expressly states that a CDC must apply to SBA to expand its area of operations into a local economic area (see § 120.835). Some comments were in favor of revising the definition of local economic area or area of operations in ways that would remove or create exceptions to the requirement that a CDC apply to SBA to serve a local economic area; one comment proposed that a CDC's minimum area of operations include all local economic areas adjacent to a CDC's state of incorporation. SBA did not propose to change the definition of local economic area in this way and considers to be beyond the scope of this rulemaking the requirement that a CDC apply to SBA to cover such areas.

The definition for ''Associate Development Company'' is deleted. This change is discussed in the analysis of revisions for § 120.850. SBA received several comments in support of the proposed change.

Other regulations in Subpart H of part 120 use the terms ''Designated Attorney,'' ''Lead SBA Office'' and ''Priority CDC.'' For clarification, SBA is adding definitions for those terms. Comments received supported these additional definitions. SBA did not receive any comments objecting to these new definitions.

In § 120.810, application for certification as a CDC, SBA is changing the policies governing new CDC applications to reflect the change in the definition of a CDC's ''Area of Operations'' to a minimum of statewide. Additionally, it deletes the current restrictions that permit existing CDCs to exclude geographic areas from being considered for a new CDC. SBA is permitting the marketplace to determine the optimum number of CDCs that may be supported. In this section and in several others (for example, § 120.812(d) and § 120.837), SBA proposed to add the phrase ''The procedures of §§ 120.855 through 120.857 do not apply'' to the specific action described in the proposed regulation section. Several commenters expressed confusion as to whether SBA was proposing to change existing rights or add new rights to reconsideration or appeal from the SBA action addressed in that regulation. Several commenters also requested that SBA expand these sections further to specifically provide CDCs a right of administrative appeal to SBA's Office of Hearings and Appeals (OHA), under part 134 of SBA's regulations, for each such action.

By adding this phrase to this section and others, SBA did not intend and did not propose to add any new administrative appeal rights to these sections. On the contrary, SBA was attempting to clarify that the expanded SBA enforcement and CDC administrative appeal rights proposed in §§ 120.855 through 120.857 for actions described in § 120.854 specifically would not apply to the sections in which the phrase would appear. Because this appears to have caused confusion rather than provide clarification, SBA's final rule deletes the phrase beginning with ''The procedures of §§ 120.855 through 120.857* * *'' wherever it appeared in the proposed rule. This results in the preservation of the procedures that currently exist under SBA regulations in subpart H of this part and in §§ 134.102(d) and (f) of this chapter, namely that only in cases in which a right of administrative appeal to OHA is specifically set forth by regulation does such a right exist. As discussed below regarding § 120.856, SBA has added § 120.856(f) clarifying that the procedures in § 120.856 only apply to actions taken by SBA pursuant to § 120.855.

Also, SBA is adding a clarification that an applicant CDC must demonstrate financial capability to meet the upfront costs of the program until the CDC's operations meet the breakeven point. This is to ensure that the CDC will be staffed sufficiently to meet the requirements of marketing, processing, closing, and servicing 504 loans. The added requirement that an applicant must demonstrate financial capability to meet the upfront costs of the 504 Program until the CDC's operations meet the breakeven point should assist in attracting only those applicants committed to devoting adequate resources (refer to § 120.802 discussion on the comments regarding changes to CDC area of operations). Several commenters objected to the proposed rule on the basis that the current ''adequately served'' concept applicable

to new applicants, which limits the geographic areas that are available for new CDCs, assists in minimizing the number of processing and closing problems from inexperienced CDCs. SBA considered these concerns but continues to believe that the marketplace should determine the maximum number of CDCs that may be supported by 504 loan activity within a State.

SBA received several comments about the proposed deletion of the requirement in § 120.811 for public notice as well as direct notice to existing CDCs for new CDC applications (as well as in § 120.836 for CDC expansion requests). Several commenters were concerned that the deletion of the requirement for notice to the public and to existing CDCs would not give existing CDCs with knowledge of the community an opportunity to express their opinion about a new CDC application request or a CDC expansion request. SBA considered this concern but decided not to modify the proposed rule.

In SBA's experience, most of the comments received in response to such notice to CDCs and the public have been from existing CDCs concerned about ''ruinous competition'' that would result from CDC expansion; SBA has received very few comments concerning new CDC applications that have resulted in information that SBA had not already discovered in its own review process. With the new emphasis on competition in the 504 Program as a result of this final rule, the issue of competition resulting from a CDC's expansion will no longer be relevant to SBA's decision.

With regard to decisions on new CDC applications, SBA has an established, effective process for screening and conducting appropriate due diligence and character determinations on the officers, directors, and key staff of an applicant for certification as a CDC. SBA's current process addresses all comments SBA may receive concerning such applicant or any individual associated with the applicant. Eliminating the public notice requirement will not change that process or eliminate SBA's consideration of any comments it may receive. In addition, all new CDCs are subject to a two year probationary period (pursuant to § 120.812), during which time significant, adverse character or other issues relating to the new CDC may come to light (through comments by members of the public or otherwise).

Finally, SBA believes that elimination of the notice requirement will streamline the application process for both new CDCs and for CDC expansions and decrease the cost and time necessary for a CDC to pursue either type of application. For all of these reasons, the final rule deletes § 120.811.

Section 120.812, probationary period for newly certified CDCs, is revised to clarify how SBA will process a CDC's petition for permanent CDC status, and that the probationary period commences on the date of certification. Also SBA is deleting all references to ADCs in connection with the elimination of the ADC program (see discussion under § 120.850). In this final rule, SBA also eliminates the last sentence in this regulation that the procedures in §§ 120.855 through 120.857 do not apply, for the same reasons discussed above for § 120.810.

In § 120.820, CDC non-profit status, SBA describes what the Agency means by the term ''good standing.'' While this is a term that has been used over the years in administering the 504 Program, SBA has not fully defined it previously. Several comments expressed concern about SBA's ability to analyze a CDC's compliance with laws, including taxation requirements. The comments seem to suggest that SBA should not have the right to consider a CDC's compliance with other laws that govern the CDC when considering whether the CDC is in good standing. SBA disagrees and continues to believe that a CDC's compliance with all laws governing a CDC should be a part of SBA's analysis, as the regulator overseeing CDCs, of whether a CDC is in good standing. SBA has no intention of ensuring that CDCs comply with all laws, but it has the means (through publicly available information, for example) to ascertain when a CDC is not in compliance with tax and other legal requirements. Therefore, SBA adopts § 120.820 as it was published in the proposed rule.

Section 120.821, CDC Area of Operations, is revised to delete the limitation of one statewide CDC since all CDCs' areas of operations will be at least statewide (see discussion of definition of the ''Area of Operations'' under § 120.802).

Section 120.822, CDC membership, is revised to streamline CDC membership qualifications by deleting the requirement that a CDC's membership must be representative of its entire area of operations. Currently, a CDC must have representation from each of the four groups (*i.e.*, government organizations, financial institutions, community organizations, and businesses) for its entire area of operations. With this change, SBA will still require that each of the four groups be represented in the membership, but will no longer require that such members represent the entire area of operations. SBA also is eliminating the requirement that SBA pre-approve the CDC's members representing government organizations, and is adding small business development companies (''SBDCs'') and other types of community organizations that may be a source of members for a CDC. It will be up to the CDC's board to determine how broadly-based geographically the membership needs to be to meet the CDC's economic development objectives. The CDC's board may choose to have a membership that represents only a county, or some counties, while another CDC's board may choose to have a membership that represents the entire State.

Several comments suggested that the regulation may need some clarifying language by stating specifically that the membership groups need not have members that do not represent the entire area of operations. SBA considered these comments but disagrees that further clarification is required. Section 120.822(b) as proposed specifically states that ''Members must be responsible for actively supporting economic development in the Area of Operations,'' and the preamble to the proposed rule SBA clarified that ''With this change, SBA still would require that each of the four groups be represented in the membership, but would no longer require that such members represent the entire area of operations.'' SBA is publishing § 120.822 as proposed.

Other comments suggested that a CDC should be able to use CDC employees in meeting the membership requirements. SBA considered these comments but disagrees. The membership requirement is designed to be filled by local community leaders volunteering to assist in providing economic development in their communities through the formation of a CDC. The membership elects the CDC's board from among its members. The board, in turn, hires paid professional staff to operate the CDC on a daily basis. SBA believes that this will preserve objectivity between the CDC's membership, its board, and its staff. Therefore, SBA is publishing in the final rule § 120.822 as it was published in the proposed rule.

Section 120.823, CDC board of directors, is revised to delete the requirement that a CDC that is approved as a multi-state CDC meet the CDC board requirements for each State. SBA did not propose this specific change to § 120.823(b) in the proposed rule. However, SBA did discuss in the preamble to the proposed rule SBA's

intent to change the requirement currently in § 120.823(b) that a multi-state CDC must meet the board requirements set forth in § 120.823 for each State in which it is authorized to operate (see preamble discussion, ''Overview of Proposed Changes to the 504 Regulations,'' last full paragraph, column one, 68 FR 40556). In addition, this change is consistent with the changes SBA did specifically propose to § 120.835(c) concerning a CDC requesting a multi-state expansion. SBA also received several comments in support of this change. Because this change is consistent with SBA's intent as expressed in the proposed rule and with other changes specifically proposed and is supported by the public, SBA revises § 120.823(b) in this final rule. With this change and the change to § 120.835, a multi-state CDC will be required to meet the loan committee (§ 120.823(b)) and membership (§ 120.822(b)) requirements for each State in which it operates as a CDC, and the CDC's board would need to establish a loan committee in each such State, but would not need to meet the other board requirements (§ 120.823) for each such State.

Section 120.824, professional management and staff, is revised to modify the requirements for when and under what circumstances a CDC can contract for management services. The change clarifies the requirements regarding CDC staff provided under contract including deleting the requirement that a contractor must live or do business in the CDC's area of operations. SBA believes that a CDC may wish to contract for certain services, such as ''back office'' staff support, with individuals or organizations that are outside of the CDC's area of operations.

The comments were generally supportive of this change but several expressed concerns regarding SBA's current requirement that a CDC's manager must be employed directly unless contributed by a non-profit affiliate of that CDC that has the economic development of the CDC's area of operations as one of its principal activities. This is a requirement currently in § 120.824(a)(2) and SBA did not propose to change this requirement; therefore, these comments are beyond the scope of this rulemaking.

Several commenters also objected to SBA's proposed deletion of the exception in the current § 120.824(a)(1) concerning the circumstances under which a rural CDC may contract with another CDC for management services, on the basis that the exception for small rural CDCs is specified by the Act. SBA recognizes that section 503(e)(2) of the Act allows a rural CDC a waiver if it contracts with another CDC covering the same area. In SBA's experience this waiver provision has never been used. However, SBA will process all rural CDC waivers in accordance with the Act. Therefore, SBA added back to § 120.824 as proposed, a paragraph (a)(2) specifically addressing rural CDCs, to clarify that there is no change to the status quo regarding such waivers for rural CDCs.

SBA also received some comments on the changes to the proposed clarified options of the CDC board's role in hiring and terminating the CDC's manager, either as a direct employee or through a contract when provided by a non-profit affiliate. The comments suggested that there may be other ways that a CDC's manager may be hired or terminated. However, the board of a CDC bears the ultimate responsibility for the CDC and its management and SBA believes it is appropriate to expect the CDC's board to control these decisions. Except for the change discussed, SBA is publishing in the final rule § 120.824 as proposed.

As set forth in the proposed rule, § 120.826, basic requirements for operating a CDC, is slightly reworded for clarity. As also proposed, the responsibilities currently described in § 120.827(a) are moved to this section because SBA considers them to be basic requirements for operating a CDC. In addition, SBA is clarifying that all CDCs must comply with all of the 504 Program requirements imposed by statute, regulation, SOP, policy and procedural notice, loan authorization, debenture, or any agreement between SBA and the CDC. Comments generally were supportive of the changes. Therefore, SBA is adopting § 120.826, basic requirements for operating a CDC, as it was proposed.

Section 120.827, other services a CDC may provide to small businesses, is revised to focus this section only on, and clarify what is meant by, ''other services'' that a CDC may provide to a small business, as well as describe the regulations to which the CDC will be subject if it does provide such other services. Comments generally were supportive of the changes although a few expressed concern regarding the deletion of the current regulation § 120.827(c) which provides that a CDC may lend to a borrower the amount of the required borrower contribution. SBA had proposed to delete § 120.827(c) because that provision is already included in § 120.912, which is not being amended in this rule and, therefore, is redundant in this section. Therefore, SBA is adopting the final rule § 120.827 as proposed.

Section 120.828, minimum level of 504 loan activity and restrictions on portfolio concentrations, is reworded to clarify the minimum level of 504 loan activity a CDC must maintain. In addition, this section covers the requirement concerning portfolio concentrations currently contained in § 120.827(a) and the heading to the section is revised accordingly. Comments were generally supportive of the proposed changes, although some expressed concern that CDCs with small portfolios may not be able to meet the portfolio concentration requirements. SBA considered this concern but was not persuaded since this requirement already exists in § 120.827(a) and SBA knows of no CDC that has not met this requirement. Therefore, SBA is adopting the final rule § 120.828 as proposed.

Section 120.829, job opportunity average a CDC must maintain, modifies the job opportunity average a CDC must currently maintain by changing it to an amount specified by SBA by means of a notice published in the **Federal Register**. Currently, the average stated in § 120.829(a) is preventing many CDCs from accepting 504 loan applications from small businesses for loans that would not create jobs but would meet other statutory 504 Program objectives, such as loans to increase business efficiency through technology. In addition, the present ratio has been in effect since 1990 and does not take into account the inflationary factors in the cost of land, real estate acquisition, construction, and machinery and equipment since that time. Finally, SBA is clarifying that a new CDC is permitted two years from the date it is certified to meet the job portfolio requirement. Several commenters were concerned that the change would not give SBA enough flexibility and would eliminate the special circumstances under which a CDC's portfolio could average a higher job per dollar ratio. SBA considered these comments but believes that the rule as proposed does permit flexibility. In addition, the rule has not eliminated the special exceptions. The only thing that will change is the means by which SBA changes the job opportunity average. SBA will revise the average periodically, based on appropriate economic factors, and will publish the revised average in the **Federal Register** as a notice, rather than as a regulatory change. Therefore, SBA has adopted § 120.829 in the final rule as proposed.

Section 120.830, reports a CDC must submit, is revised to change the submission requirement for CDC annual reports to 180 days after the end of the

CDC's fiscal year to permit CDCs more time to provide financial statements with the required level of review. The final rule also clarifies the requirement by adding that the annual report must include financial statements of any affiliate or subsidiary of the CDC. In addition, it adds some clarifying language regarding the submission requirements for changes to directors or staff. Several comments requested that the submission requirement be increased further than the 120 days SBA had proposed, to 180 days, due to the complicated nature of some audits. SBA considered these concerns and agrees that a longer timeframe may be necessary. Part of the reason to increase the timeframe is that SBA is requiring the financial statements of any affiliates of the CDC. Therefore, to accommodate the more complicated audits, the final rule provides for 180 days.

Several commenters also expressed concern about SBA's proposed change that the financial statement submission includes any affiliates of the CDC. The current regulations define concerns as affiliates of each other when one concern controls or has the power to control the other, or a third party or parties controls or has the power to control both (see § 121.103(a) of this chapter). SBA is the agency that certifies CDCs and is their sole regulatory oversight agency. As part of its oversight responsibilities, SBA believes that it should review the financial statements of those affiliates that the CDC controls or that may control the CDC, because such affiliates may have some control over the CDC's 504 Program activities even though they may not be involved directly in conducting those activities, or because such affiliates may present issues of potential conflicts of interest with or financial harm to the CDC. Therefore, the final rule concerning financial statement submission requirements adopts the rule as proposed.

Several commenters also expressed concern about SBA's proposed requirements for a statement of personal history and other information to be submitted for new associates. The commenters appeared to suggest—incorrectly—that this is a new requirement. Section 120.830 currently requires CDCs to submit to SBA for review and approval the ''resumes for all new Associates and staff.'' SBA's longstanding procedure has been to require statements of personal history, fingerprint cards, and resumes for all such individuals, just as SBA requires for all individuals identified in the CDC's initial application for certification. (See SBA standard operating procedures 50–10(4), subpart H, chapter 4, paragraph 5(d)(1).) As the sole regulatory oversight agency for CDCs, SBA is responsible for performing the necessary due diligence to assure that new associates and staff meet certain ethical and experience standards. Therefore, in order to make the rule reflective of SBA's longstanding practice, SBA is publishing in the final rule § 120.830 as proposed.

Section 120.835, application to expand an area of operations, is revised. Currently, most of the applications SBA receives are for expansions of a CDC's area of operations within its State of incorporation. The expansion request usually is for several counties in which there currently are one or more CDCs that include those counties in their areas of operations. Because the final rule establishes the State of incorporation as the minimum area of operations for all CDCs and because SBA is allowing the marketplace to determine the optimum number of CDCs, these types of expansion requests no longer will be necessary and much of the current regulatory language is no longer required (refer to discussion of changes to § 120.802 and § 120.810). Therefore, SBA has modified the regulation to limit SBA's consideration of applications for expansion to only those requests by a CDC to expand beyond the CDC's State of incorporation either to a local economic area contiguous to the State in which the CDC is incorporated, or to an entire State contiguous to such State.

SBA also has added the requirement that CDCs must be ALP-qualified before they can request either type of expansion. Several commenters expressed concern that this new requirement will make it more difficult for a CDC to expand beyond its area of operations. SBA reiterates that with the minimum area of operations being Statewide, there will be far less need for CDCs to request the right to expand because SBA believes that the majority of CDCs will not wish to expand beyond their own State. For a CDC that wishes to expand into local economic areas or entire States outside its State of incorporation, however, it is important that such CDC be of a sufficient size and at a sufficient level of proficiency in the 504 Program to be able to adequately cover territory beyond its State. SBA is concerned about, among other things, the CDC's portfolio size and currency, performance as a CDC, and whether the CDC has sufficient proficiency with loan closing (*i.e.*, has a designated attorney and the necessary insurance coverage to be able to participate in SBA's expedited loan closing process) and that the CDC is knowledgeable of applicable law in other States, to be able to handle the additional territory without presenting an undue risk to SBA's overall 504 loan portfolio. For these reasons, the final rule requires a CDC requesting expansion of its territory beyond its State of incorporation to be ALP-qualified, as proposed.

To further streamline the application process for multi-state expansion, SBA is deleting the requirement that a multi-state CDC have at least three members from each State on its board. SBA believes that the general membership requirements (see § 120.822) and loan committee requirements (see § 120.823) for the State into which it is expanding are sufficient to demonstrate the CDC's commitment to local economic development in that State. (To be consistent with this deletion in § 120.835 regarding the board requirements, SBA also is modifying § 120.823(b).) A discussion of the comments received regarding the minimum area of operations and local economic areas may be found under § 120.802. SBA also received comments regarding multi-state CDC requirements that were not proposed for change, including membership and loan committee requirements, and were, therefore, beyond the scope of this rulemaking. They may be considered as part of a proposed rule at some future date. Therefore, SBA is publishing in the final rule § 120.835 as proposed.

Section 120.836, public notice, and opportunity for response, is deleted. SBA believes that the requirement is no longer needed for the same reasons discussed regarding § 120.811. The final rule deletes § 120.836 as proposed.

Section 120.837, SBA decision on application for a new CDC or for an existing CDC to expand an area of operations, streamlines the process by changing the paragraph on a multi-state CDC to permit any unilateral authority that a CDC has in its State of incorporation to be carried over into the additional State in which it is approved to operate as a multi-state CDC and clarifying SBA's decision process. Comments received generally were in support of the proposed changes. However, several commenters suggested that the proposed changes seemed to have deleted the decision process for new CDCs and CDCs expanding into local economic areas. After reviewing the proposed rule, including the summary which stated that the regulation was to continue to cover both new CDCs and expanding CDCs, SBA agreed with the commenters and has modified the rule. SBA reviewed the proposed rule and determined that

while SBA had stated in the preamble that the regulation was to continue to cover SBA's decision with respect to new CDCs, CDCs expanding into local economic areas, and CDCs becoming multi-state CDCs, the proposed revision to the heading of the section was misleading. SBA therefore makes clarifying changes to both the heading and to § 120.837(b). Also the commenters found the reference to the enforcement regulations not applying in these cases to be confusing. SBA has deleted the reference to the enforcement regulations, §§ 120.855 through 120.857, for the same reasons discussed regarding § 120.810.

Section 120.838, expiration of existing, temporary expansions, was a short-term regulation to manage the conversion of existing temporary expansions into permanent expansions by March 1, 1996, and is no longer required. Comments received generally supported the proposed deletion of this regulation. Therefore, the final rule adopts the deletion of the regulation as was proposed.

Section 120.839, case-by-case extensions, gives a district office the authority to make all decisions concerning whether SBA will allow a CDC to make a 504 Loan outside of its area of operations (other than multi-state or local economic area expansions), and adds, as a new basis for such decision, the situation in which a State may not have a CDC. (For example, currently Alaska has no CDC.) In addition, SBA is deleting as a basis for such decision, the situation in which specific circumstances exist that prevent an existing CDC serving that area from adequately assisting the business (see § 120.839(a)(2)), because the exception has never been used and SBA's experience indicates that it is unnecessary. Comments received by SBA generally supported the proposed changes. Some commenters wanted the regulation to emphasize that the applicant CDC must demonstrate that it can properly service the 504 loan it wishes to make outside its area of operations, in addition to fulfilling its other 504 Program responsibilities for the 504 loan. Section 120.839(b) currently has this specific requirement, although SBA had proposed to expand this beyond just servicing. SBA agrees with this concern and is adding language back to the final rule that emphasizes a CDC's servicing responsibilities regarding the loan. Other commenters expressed concern that a small business may be prevented from receiving a 504 loan if CDCs covering the area are not willing to consider an application from such a business and, therefore, urged SBA to preserve existing § 120.839(a)(2). However, as SBA explained in the proposed rule, SBA's experience indicates that this provision is unnecessary since it has never been used. In addition, the change in the minimum area of operations will vastly increase many CDC's area of operations, resulting in less need for case-by-case exceptions in general since small businesses will have expanded access to and choices among CDCs. Therefore, § 120.839 is adopted as proposed except for the modifications discussed.

SBA substantially revises § 120.840, accredited lenders program to describe the ALP, the benefits a CDC will receive through the ALP, how to apply for the ALP, and how SBA will process the application. Comments received generally were supportive of the proposed change, although several expressed concern that the section does not specifically state that a CDC may seek renewal of its ALP status every two years. Even though in SBA's experience CDCs have routinely been renewed for consecutive two-year periods, SBA is modifying the regulation to state ''periods'' rather than the singular ''period''. In addition, SBA has deleted the reference to the enforcement regulations, §§ 120.855 through 120.857, for the same reasons discussed regarding § 120.810. This rule adopts § 120.840 as proposed except for the modifications discussed.

In § 120.841, SBA is establishing more detailed qualifications for the ALP. The standards are consistent with section 507 of the Act and coordinate with eligibility requirements for CDC participation in the PCLP (see § 120.845 discussion below). These changes will make it easier for SBA to provide consistent and objective evaluation of a CDC application to participate in the ALP.

Several commenters asked for additional clarity regarding the qualification requirements of the CDC's staff. In light of those comments, SBA reviewed the proposed rule and agreed there should not be two sections on CDC staff qualification requirements. Accordingly, SBA has consolidated the two paragraphs regarding staff experience into one paragraph as well as added some clarifying language.

SBA received several comments pointing out that the PCLP regulations permit some flexibility in SBA's determination of whether a CDC is in compliance with 504 Program requirements by introducing the concept of ''substantially,'' whereas the ALP regulations do not. Since one of the requirements to be a PCLP CDC is to qualify as an ALP CDC, it would be inconsistent to not permit the same flexibility in the ALP regulations. Therefore, SBA has modified this section to apply the concept of ''substantially'' to compliance with ALP requirements as well.

SBA received several comments regarding proposed § 120.841(d) which indicated that a CDC must meet SBA's CDC portfolio benchmarks. The comments raised concerns regarding the accuracy of the benchmarks and alleged that the benchmarks were not developed through a public comment process. Several comments also stated that use of the benchmarks would not be fair, to the extent that a CDC's default rate was derived from loans that are approved by SBA or to the extent that a CDC's loss rate was derived from liquidation and debt-collection litigation that was handled by SBA or the Department of Justice. Since these actions were not subject to the control of the CDC, the comments contended, it would be unfair for SBA to consider the CDC to be not in compliance with 504 Program requirements based on the relevant benchmark score. These comments recommended that SBA either delete or modify the language regarding the portfolio benchmarks in § 120.841(d). Several commenters questioned SBA's authority to establish portfolio performance benchmarks in the first instance.

SBA strongly disagrees with those comments. SBA has responsibility, as 100% guarantor of each debenture issued by CDCs and as the sole regulatory oversight agency for CDCs, to protect the safety and soundness of the 504 Program. CDCs are established by SBA, with the responsibility to identify and approve only those 504 loans that are eligible, creditworthy, sufficiently collateralized, and have a reasonable expectation, based on the CDC's thorough financial analysis, of timely repayment. CDCs also are required to close 504 loans in compliance with SBA's loan authorization and other requirements. CDCs also must adequately service loans. While SBA may retain the right to review some aspects of the CDC's approval, closing, and servicing activities (depending on the status of the CDC), this review does not negate the CDC's responsibility to comply with 504 Program requirements and act in a prudent, commercially reasonable manner with respect to these activities. SBA may have a greater degree of control over 504 loan liquidation activities, depending on the status of the CDC, but the amount of loan recoveries during liquidation depends to a great degree on the initial

underwriting and subsequent servicing decisions made by the CDC.

In order to more effectively fulfill SBA's responsibility to monitor and oversee CDCs' activities, several years ago SBA established a means of collecting 504 loan performance information for each CDC, in five areas: Currency, delinquency, default, liquidation, and loss. SBA then used this information to determine the level (benchmark) of performance that SBA considers to present an acceptable level of risk to SBA's overall 504 loan portfolio for each of the five areas. Beginning in 1999, SBA issued a series of notices informing CDCs about this CDC performance information system, identified where the information regarding each CDC's performance was available, and advising CDCs that SBA would be using the system to evaluate each CDC. In addition to the notices, SBA explained to the CDC community the system and the sources of information used in the system, at several national conferences as well as by providing information on SBA's internet website. Thus, the proposed rule was not the first time CDCs received notice about the benchmarks. SBA believes that evaluating the performance of each CDC is an essential part of SBA's overall responsibility to manage the 504 Program so as to minimize the financial risk to the taxpayers.

Several comments attempted to show that the benchmarks were not accurate, relying on the argument that SBA has altered its measure of the 504 Program subsidy rate over the past decade (although the comments did not clarify how this measure has any direct application to the benchmark scores). However, SBA finds it highly significant that not one comment identified a specific case where the portfolio performance scores for a particular CDC were found to be inaccurate. SBA provides CDCs with their benchmark scores on a monthly basis (the scores soon will be available to CDCs directly through the Internet rather than through their district offices), and in those few cases where CDCs have brought to SBA's attention concerns about the accuracy of a particular benchmark score SBA has consistently worked with the CDC to understand the basis for the concern and make any necessary corrections. Thus, SBA believes the benchmarks overall are accurate and are a reliable means of measuring a CDC's performance, particularly because all CDCs are subject to the same criteria and because individual CDCs are measured against other CDCs in their tier with similar portfolio sizes.

In the context of a specific finding by SBA, relying on a CDC's portfolio benchmark score as evidence that the CDC was not in compliance with 504 Program requirements, the CDC, having access to its score and having its own information about the performance of its loan portfolio, would be able to present to SBA its arguments that the benchmark score was inaccurate and SBA would carefully consider those comments before proceeding to take any action using the score as evidence in support of such action.

SBA has considered the comments concerning the portfolio benchmarks in § 120.841(d) in the proposed rule, and in the final rule modifies this section so it will be consistent with § 120.854(d), which addresses a CDC's failure to meet one or more portfolio benchmarks as evidence of its failure to perform underwriting, closing, servicing, liquidation, litigation, or other actions with respect to 504 loans in a commercially unreasonable or imprudent manner. As a result of this change, SBA will consider a CDC's performance on the portfolio benchmarks to be a measure, indicator, or evidence of how the CDC is complying with various 504 Program requirements.

This final rule adopts § 120.841 as proposed except as discussed.

Section 120.845, premier certified lenders program, is implemented as proposed except for one change. SBA added the word ''substantially'' to § 120.845(c)(1) for the reasons discussed for § 120.841.

The PCLP is now a permanent program pursuant to section 508 of the Act. SBA is adding considerably more detail to § 120.845 and moving some of its revised and expanded provisions to new §§ 120.846–120.848. Since CDCs participating in the PCLP must be approved to participate under the ALP or be ''ALP qualified,'' SBA is adding some of the PCLP requirements to § 120.841.

The PCLP is designed to take advantage of the proven loan processing and servicing skills of SBA's most proficient and most active CDCs. It is a relatively new program (started in 1994 as a pilot program) with a somewhat limited operating history. Because SBA transfers substantial additional authority to CDCs, the PCLP carries potentially significant risk to SBA and the 504 Program. Therefore, SBA intends to closely monitor and control program implementation and expansion. With respect to SBA's prior review of a 504 Loan at the loan approval stage, SBA is interested in limiting/minimizing its involvement in reviewing 504 Loans made by PCLP CDCs. While, initially, SBA expects to continue to review loan eligibility while delegating virtually all credit decisions to PCLP CDCs, SBA will consider expanding or reducing that authority as warranted by the results of the program.

Participation in the PCLP, pursuant to section 508(b) of the Act, is limited to those CDCs that are active in the 504 Program; are in good standing with SBA; have demonstrated the ability to properly analyze, close and service 504 Loans; and have been active as ALP CDCs. Section 508(b)(2)(A) of the Act allows SBA to waive the requirement for those non-ALP CDCs that meet the ALP participation criteria. However, rather than developing a waiver process, SBA is incorporating the ALP participation criteria into the PCLP participation criteria (see § 120.845(c)(1)).

Based on the guidance in the statute, and following extensive discussion with the CDC industry, SBA developed more specific factors to be used in evaluating a CDC's level of activity; ability to properly analyze, close, service and liquidate 504 Loans; and good standing. Each factor represents a major and essential CDC function, and each carries significant risk to SBA and the 504 Program. Because SBA delegates substantial authority and autonomy to PCLP CDCs, it considers each factor important, and a substantive deficiency in any one may preclude participation in the PCLP. SBA will use information from onsite compliance reviews, operational reviews and other program management and oversight activities to make the determination regarding eligibility for PCLP status.

Congress, SBA and the CDC industry recognize that the success of the PCLP is highly dependent on the extent to which PCLP CDCs are familiar with SBA's credit and eligibility standards and its loan processing, closing, servicing and liquidation policies and procedures. These policies and procedures are highly complex and require processing a substantial volume of 504 Loans over an extended period of time to remain proficient. Also, SBA needs access to a significant number of a CDC's loans to evaluate its proficiency. SBA notes that ALP its participants must have processed at least twenty 504 Loans in the most recent three years (see § 120.841(b)). When considering the minimum 504 Loan volume requirement for participation in the PCLP, SBA considered the concern of smaller and rural CDCs that a high minimum 504 Loan volume requirement could exclude them from being a PCLP CDC. SBA discussed those concerns with the CDC

industry and concluded that proficiency in 504 Loan policies and procedures can only be developed and maintained from regularly processing a significant number of 504 Loans. In addition, one of the main purposes of the PCLP was to improve the efficiency and expedite the loan processing of higher volume CDCs, which were being disproportionately impacted by the longer turn-around time in SBA's district offices. Also, for low volume CDCs, any potential efficiency benefits from participating in the PCLP would more than likely be offset by the cost and effort required to develop and maintain the high level of 504 Loan proficiency required in a staff that rarely processes an SBA 504 Loan. (About half of all CDCs process less than six 504 Loan applications per year.) After considering these issues, SBA proposes to require that ALP and PCLP applicants must have received approval for at least 20 504 loans in the most recent three years and have a portfolio of at least 30 active 504 loans. (SBA defines an ''active'' 504 Loan as a loan that was approved and closed by the CDC and has a status of either current, delinquent, or in liquidation.)

To assist in determining the proficiency of a PCLP applicant to effectively process and administer 504 Loans, SBA is requiring that SBA-conducted oversight reviews of a PCLP applicant must have found the applicant to be substantially in compliance with SBA's regulations, policies and procedures. In addition, SBA will need to assess the applicant's current proficiency, so these reviews must be relatively recent (within the past 12 months). While SBA has policy and procedural guidance in place generally requiring annual SBA oversight review, CDCs may occasionally request a postponement of those reviews. Applicants to the PCLP must recognize the need for current SBA review data and coordinate with their Lead SBA Office to ensure that the CDC is available and prepared for any required oversight reviews.

SBA has developed comprehensive management information systems to timely track and analyze the performance of a CDC's 504 Loan portfolio. As a result of an extensive examination and analysis of these performance data, SBA has determined that portfolio currency, delinquency, default, liquidation and loss rates are important measures of the quality of a CDC's portfolio and the effectiveness and diligence of its loan analysis, closing and servicing. Therefore, SBA has established benchmarks for each of these measures and SBA will use such portfolio benchmarks as an indication or measure of the CDC's compliance with 504 program requirements.

SBA and the CDC industry recognize that the training and experience of the PCLP applicant's staff are critical determinants of the quality and effectiveness of its 504 Loan program administration as well as its diligence in applying SBA's 504 Loan credit and eligibility standards. As a result, the CDC industry has developed appropriate credit, packaging, loan closing and loan servicing training programs, which the staff of many CDCs attend. As a result, SBA is requiring that the principal staff of PCLP applicants possess adequate 504 Loan training and experience.

Under the PCLP, SBA delegates authority and a certain level of autonomy to PCLP CDCs to process, close and service 504 Loans with only limited prior SBA review. As a result, SBA is requiring that applicants to the PCLP must demonstrate a particularly thorough understanding of and an applied diligence to SBA's 504 Loan credit and eligibility standards and its 504 Loan processing, closing and servicing policies and procedures. A failure to consistently apply appropriate credit analyses and standards and loan processing, closing and servicing policies or procedures exposes SBA and the taxpayer to excessive risk of loss and negatively impacts the availability of SBA financing to the small business community. A CDC's failure to adequately apply SBA's 504 Loan eligibility standards could result in 504 Loan approvals to small businesses that are expressly prohibited by statute or regulation from receiving SBA loans.

Section 508(b)(2)(A) requires that PCLP CDCs be in good standing with SBA. SBA interprets that requirement to mean both in good standing with the State in which the CDC is incorporated (as discussed in § 120.820), and in substantial compliance with the 504 Program requirements imposed by statute, regulation, SOP, policy and procedural notice, loan authorization, debenture, or any agreement between SBA and the CDC. Under the PCLP, due to the higher level of authority delegated to the PCLP CDCs and the potential risk to the Agency, SBA expects a significantly higher level of compliance with both of these requirements by PCLP CDCs.

The Lead SBA Office will consider the CDC's initial application to the PCLP, and will forward the application package, including a recommendation regarding the applicant's qualifications, to SBA's PCLP Processing Center, which then will forward the package with its recommendation to the AA/FA for final action. PCLP applicants are expected to coordinate with their Lead SBA Office early in their consideration of the PCLP to realistically assess its program requirements and their prospects for admission. When officially applying for the PCLP, an applicant will need to provide certain essential information and documentation to assist SBA in ascertaining its qualifications, including a resolution from its Boards of Directors; resumes on key staff for 504 Loan processing, servicing, liquidation, and litigation; documentation of any required insurance; and information about the qualifications of its closing attorney. While SBA will generally confer PCLP status for a period of two years, under appropriate conditions SBA may approve a lesser period.

Section 120.846, requirements for maintaining and renewing PCLP status, is added. Pursuant to section 508(b)(3) of the Act, in order to retain its PCLP status, a PCLP CDC must continue to meet the eligibility requirements of the PCLP, as described in § 120.845. While level of activity is one of those criteria, section 508(i) of the Act requires that PCLP CDCs establish a goal of processing a minimum of 50 percent of their 504 Loan applications using PCLP procedures. SBA considered establishing a requirement that PCLP CDCs process at least 30 percent of their 504 Loans using PCLP procedures immediately after becoming a PCLP CDC and gradually increasing that requirement as the PCLP CDC matures. However, following discussions with the CDC industry, SBA determined that immediately establishing such an absolute minimum could discourage participation in what is a developing program with a variety of relatively new concepts and procedures. Nevertheless, SBA recognizes that the legislation authorizing PCLP mandates that PCLP CDCs be active CDC lenders and establish a goal of processing a minimum of 50 percent of their 504 Loans using PCLP procedures. As a result, while SBA still expects PCLP CDCs to process a substantial proportion of their 504 Loans using PCLP procedures and strive to reach their 50 percent goal as mandated by statute, SBA is not immediately requiring an absolute minimum. Thus, as the PCLP matures, SBA intends to publish procedural guidance gradually incorporating and increasing the minimum number and percent of 504 Loans that PCLP CDCs must process using PCLP procedures.

Due to the delegation of authority under the PCLP, and the associated risk of loss, SBA expects PCLP CDCs to

develop, implement and actively monitor effective internal control systems and processes that will ensure continued conformance with the requirements of the PCLP. These systems should provide PCLP CDCs with early information on their performance. SBA also has developed management control systems to monitor individual PCLP CDCs, specifically the portfolio benchmark data and the management oversight reviews, and SBA provides this information to PCLP CDCs. With these internal and external control systems, SBA expects PCLP CDCs to constantly monitor their performance as a CDC and as a PCLP CDC and to be in a position to take appropriate and timely corrective action when necessary. Due to the risk inherent in the delegation of authority under the PCLP, SBA will move to timely suspend, terminate or decline to renew the PCLP status of PCLP CDCs that do not comply with the requirements of the PCLP. Significant problems with respect to liquidation and litigation activities by either a PCLP CDC or its contractor may, at SBA's option, also lead to the non-renewal of PCLP status.

Section 120.847, requirements for the loan loss reserve fund, is implemented as proposed, except for one change as discussed below.

To mitigate some of the potential risk of delegating additional authority to PCLP CDCs, pursuant to section 508(c)(1) of the Act, PCLP CDCs must establish and make deposits to a Loan Loss Reserve Fund (''LLRF''). The LLRF is a restricted account established for the purpose of accumulating deposits and limiting withdrawals to those SBA specifically authorizes. The PCLP CDC may use the deposits to reimburse SBA for 10 percent of any loss sustained by SBA as a result of a default in the payment of principal or interest on a debenture issued by the PCLP CDC using PCLP procedures (''PCLP debenture''). Pursuant to section 508(c)(3) of the Act, the LLRF must be composed of: (1) Segregated deposit accounts at one or more federally insured depository institutions subject to a collateral assignment to SBA; (2) irrevocable letters of credit in favor of SBA; or (3) some combination of the above. Due to the characteristics and cost of letters of credit, and in consultation with the CDC industry, SBA has determined that letters of credit do not currently represent a feasible option for PCLP CDCs. Consequently, SBA is not addressing letters of credit in this rule. However, SBA will continue to explore this option with the CDC industry, and will promulgate regulations addressing letters of credit to the extent this becomes a feasible option.

Pursuant to section 508(b)(2)(c) of the Act, PCLP CDCs must reimburse SBA for 10 percent of any loss SBA incurs in connection with a default on a PCLP debenture and the regulation proposes how to measure SBA's loss. The statute and proposed rule also require that the LLRF maintain a deposit equal to one percent of the original principal amount of each PCLP debenture.

The LLRF must be a deposit account with a federally insured depository institution selected by the PCLP CDC. Following discussions with the CDC industry, SBA is aware that alternative accounts and financial instruments may offer greater returns on the LLRF. However, the Act restricts LLRFs to federally insured depository institutions and that language as well as other applicable law greatly limit the investment alternatives. This rule elaborates on what constitutes a deposit account acceptable to SBA. Also, to simplify the administration of the LLRF, this rule allows PCLP CDCs to pool loss reserves in a single segregated account. SBA generally does not anticipate that PCLP CDCs will incur significant fees in connection with their LLRFs, although PCLP CDCs will need to be mindful of breakage fees, should they place funds into certificates of deposit (''CDs''). This final rule goes on to make clear that the PCLP CDC will be responsible for any fees, costs and expenses incurred in connection with the LLRF.

Pursuant to section 508(c)(3) of the Act, any LLRF established by a PCLP CDC must be subject to a collateral assignment in favor of, and in a format acceptable to, SBA. Accordingly, a PCLP CDC must give SBA a first priority perfected security interest in each LLRF. The PCLP CDC must grant the security interest pursuant to a security agreement between the PCLP CDC and SBA, and the security interest must be subject to a control agreement between SBA, the PCLP CDC, and the applicable depository institution. The control agreement will include provisions requiring a depository institution to follow instructions from SBA regarding withdrawals without further consent from the PCLP CDC. The laws governing security interests in deposit accounts are complex, vary by jurisdiction, and are undergoing change. Therefore, when establishing an LLRF, a PCLP CDC must coordinate with the Lead SBA Office to develop, execute and deliver the required documentation. SBA field counsel will have a model control agreement, which they may need to modify to meet local legal requirements. This final rule provides that the CDC must provide to the Lead SBA office a fully executed original copy of the security and control agreements which the Lead SBA Office will retain in its files. All associated documents must meet SBA requirements and occasional changes may be necessary. If a depository institution will not enter into or modify a control agreement or violates the terms of any such agreement, the PCLP CDC cannot maintain an LLRF with that institution.

Pursuant to section 508(c)(4) of the Act, PCLP CDCs are allowed to make required deposits to the LLRF associated with each loan in as many as three deposits, but specifies the minimum amount and timing of those deposits. This final rule sets forth the amount and timing of those deposits.

Due to its management control and oversight responsibilities, SBA must ensure that LLRFs: (1) Are properly established; (2) contain the required reserve amounts; and (3) are appropriately administered and controlled. Periodic reporting by PCLP CDCs to SBA on the amount of funds maintained in LLRFs is critical to ensuring that LLRFs are properly established and maintained. However, while LLRFs must contain deposits equal to one percent of each PCLP debenture, the deposits associated with each PCLP debenture may be made in as many as three installments. Also, during the normal course of a PCLP CDC's operations, LLRFs will be subject to a variety of other deposits and withdrawals (*e.g.*, withdrawals associated with loans paid in full and defaults). As a result, reporting and reconciling LLRFs might become quite complex. SBA is concerned with the potential burden such reporting could represent to PCLP CDCs. SBA continues to work with the CDC industry to develop and test efficient and effective reporting procedures, and will publish appropriate procedural guidance as those procedures are finalized.

SBA will allow PCLP CDCs to withdraw any funds from the LLRFs that exceed required minimums, at SBA's discretion. Section 120.847(g) provides that requests for withdrawals must be forwarded to the Lead SBA Office, which will check the balances to ensure the required minimums are maintained and authorize withdrawals as appropriate.

Section 120.847(h) provides that when a PCLP CDC has submitted a liquidation wrap-up report to SBA, or SBA otherwise has determined that all reasonable collection efforts have been exhausted, the Lead SBA Office will calculate the SBA's loss and notify the

PCLP CDC of the amount of any reimbursement obligation and provide appropriate supporting documentation. The final rule sets forth procedures so that PCLP CDCs may appeal any problems or disagreements regarding the calculation of SBA's loss.

Section 120.847(i) requires PCLP CDCs to reimburse SBA for 10 percent of any loss and states that the reimbursement may come from the LLRF or from other funds provided by the PCLP CDC. There could also be instances where a PCLP CDC would not have sufficient funds in its LLRF to reimburse SBA for 10 percent of SBA's loss, and the regulation describes the period of time by which the CDC must reimburse the Agency.

Pursuant to section 508(c)(5) of the Act, the final rule requires that should a PCLP CDC's LLRF drop below the required minimum, the PCLP CDC must replenish the LLRF within 30 days of the time that it realizes this deficiency or of a notice from SBA that the LLRF is deficient. Thus, if a depository institution offsets from any LLRFs maintained with the institution any amounts owing by the PCLP CDC to it, the PCLP CDC must replenish the LLRF to the full amount then required within 30 days. Comments received regarding these changes concerned a perceived inconsistency in the source of reimbursement to SBA for losses. SBA considered this concern and is revising § 120.847 to clarify that a PCLP CDC may reimburse SBA for losses either from the LLRF or other funds.

Section 120.848, requirements of PCLP loan processing, closing, servicing, liquidating and litigating, is added.

Pursuant to section 508(e)(1) of the Act, PCLP CDCs are permitted to approve, authorize, close, service, and liquidate 504 Loans, subject to terms and conditions established by SBA. SBA's authority to establish such terms and conditions is limited by section 508(e)(2) of the Act, which states that the CDC's approval of a 504 Loan using its PCLP authority is subject to SBA's final approval of the PCLP debenture as to eligibility but that SBA as part of its approval may not review the creditworthiness, loan closing, and legal compliance (except with respect to eligibility) of the underlying 504 loan.

Several comments objected to the proposed § 120.848, including SBA's authority to require a PLCP CDC to process 504 Loans involving complex or problematic eligibility issues through SBA using standard loan processing procedures (§ 120.848(c)), or to require a PCLP CDC to turn over to SBA the handling of a particular PLCP loan (§ 120.848(f)). These commenters suggested that SBA does not have the authority, under section 503(e)(2) of the Act, to require that PCLP CDCs take these actions. However, SBA believes that these commenters misinterpret the Act. SBA has specific authority under section 508(e)(1) to establish the terms and conditions under which PCLP CDCs are permitted to approve, authorize, close, service, and liquidate 504 Loans, which authority encompasses all of the terms and conditions SBA proposed in the proposed rule.

Section 120.848 provides guidance on PCLP CDCs' approving, authorizing, closing, servicing, and liquidating 504 Loans and notes that all 504 Program requirements apply to 504 Loans processed by PCLP CDCs. Under § 120.848(c), PCLP CDCs are specifically authorized to determine a 504 Loan applicant's credit-worthiness; to establish the terms and conditions under which the loan will be made; and to take other processing actions as may be delegated by SBA to PCLP CDCs. SBA believes that the PCLP can be most prudently administered if SBA focuses, at least initially, on expediting the processing of routine CDC loan applications under the PCLP and handling complex or problematic eligibility issues using standard 504 Loan procedures. However, SBA will continue to study and analyze this issue and develop further guidance as the PCLP progresses.

Several comments suggested that SBA revise the requirement in § 120.848(c) that complex loan applications be processed through the Lead SBA Office, because SBA currently is expanding its centralized 504 loan processing activity. SBA considered this suggestion and agreed that this section should be modified. Therefore, in § 120.848(c) in the final rule, SBA deleted ''Lead SBA Office'' and added ''SBA,'' in order to accommodate ongoing Agency changes.

Several comments also suggested that SBA consider permitting PCLP CDCs to close their own 504 loans without SBA review. SBA notes that under § 120.848(e), a PLCP CDC is required to close PCLP loans and debentures under SBA's expedited loan closing procedures, which provides for a limited review of documents relating to the debenture, but does not include an entire review of the CDC's closing of the 504 Loan underlying that debenture. This is entirely consistent with the Act and with the comments. SBA did not propose to modify SBA's current practice, in which SBA shares with the PCLP CDC joint responsibility for closing the PLCP debenture. Refer to the discussion of § 120.960, responsibility for closing, for further discussion of SBA's reasons for not changing this current practice.

Several commenters also suggested that PLCP CDCs be permitted to make eligibility determinations which involve franchise issues and issues of potential environmental hazards and liability with respect to the project property collateral, independently and without SBA's review. SBA considered these suggestions but implements the proposed rule without change on this issue. These are important issues that relate to the eligibility for 504 loan financing of the borrower and of the project itself, and SBA has the authority under section 508(e)(2) of the Act to review and approve eligibility issues. Accordingly, SBA implements § 120.484 as proposed except as discussed.

With respect to § 120.848(b), SBA's management control and oversight responsibilities require a systematic review of a PCLP CDC's 504 loan processing proficiency. As a result, SBA must periodically review the processing actions of PCLP CDCs to ensure the PCLP CDC is using appropriate and reasonable procedures. PCLP CDCs are thus expected to retain in their loan files copies of all documents associated with their processing actions. SBA may occasionally review these documents on site or request that they be forwarded to SBA for review. If SBA identifies significant problems or deviations from SBA's 504 Program requirements, SBA will take appropriate corrective action, including possible removal from the PCLP.

SBA is deleting §§ 120.850–120.852, concerning ADCs, to eliminate the ADC designation. The reasons are twofold. First, SBA is seeking to eliminate redundancy in the regulations. One aspect of the ADC program was that it established requirements for organizations to qualify to contract with CDCs for 504-related services. However, § 120.824 permits CDCs to contract for 504-related services and governs such contracts. Second, these regulations established one of the grounds (not meeting the minimum required level of 504 Loan approval activity) for removing a CDC from the 504 Program discussed under § 120.854. In the final rule, all grounds for taking enforcement action against a CDC are combined under one regulation, § 120.854.

Section 120.855, CDC ethical requirements, is redesignated as § 120.851, and reworded to clarify its meaning and to remove the reference to ADCs (see § 120.850 discussion). SBA received several comments on this regulation. SBA proposed to delete the ''good cause'' exception to the general

rule, that an associate of a CDC may not be an officer, director, or manager of more than one CDC, and the commenters requested that such an exception remain. SBA has considered these comments but believes that, in every case, a CDC should be independently managed and operated to pursue its own economic development mission. Further, SBA believes that with the new requirement that each CDC's area of operations be statewide, a potential for a conflict of interest exists if the same individual is an officer of or on the board of two CDCs. Therefore, SBA is adopting § 120.851 as proposed.

Section 120.852 prohibits a CDC from investing in or being affiliated with a 7(a) lender or an SBIC, which SBA believes will help to avoid apparent conflicts of interest and serve the economic development mission of the CDC. However, the final rule does not require a CDC with an existing investment in an SBIC to liquidate such investment. In response to the ANPRM, commenters overwhelmingly stated that SBA should not permit a CDC to establish a 7(a) lender or permit a 7(a) lender to establish a CDC and that the two programs should remain separate. Comments in response to the proposed rule also were generally supportive of the separation of 7(a) lenders and CDCs. Several commenters suggested that there be an exception for CDCs that already are affiliated with State development companies that were authorized under section 501 of the Act that could continue to be so affiliated, even if the state development company is a 7(a) lender. SBA considered these comments and agrees to permit this exception.

SBA also received comments regarding the proposed prohibition on a CDC investing in an SBIC. A typical comment opposed the prohibition on the basis that it would eliminate a CDC's use of the SBIC program as an economic development tool (without explaining why it was believed this would occur). SBA believes the concern is unfounded. In general, if a CDC has an investment in an SBIC, then the CDC would be prohibited from referring a 504 borrower to that SBIC for that borrower's venture capital requirements. By contrast, by prohibiting a CDC itself from having an investment in an SBIC, the CDC will be free to refer its borrowers to the SBIC for venture capital, thus increasing the borrowers's access to capital. Other comments requested that the regulation be modified to be consistent with the preamble to the proposed rule, which SBA stated that the Agency would not require a CDC with an existing investment in an SBIC to liquidate such investment. SBA has considered this comment and agrees that the final rule should be modified to reflect this exception. This rule adopts § 120.882 as it was published in the proposed rule except as discussed.

Section 120.853 is identical to existing § 120.973 except that it would eliminate references to ADCs.

New § 120.854, grounds for taking enforcement action against a CDC, § 120.855, types of enforcement actions, and § 120.856, enforcement procedures, consolidate existing § 120.852 and §§ 120.982–120.984. These provisions also clarify and expand the grounds required for SBA enforcement actions against CDCs as well as SBA's and CDCs' rights and responsibilities in such actions. Section 120.981, voluntary transfer and surrender of CDC certification, is redesignated as § 120.857 to move it under the new heading entitled Enforcement Actions.

SBA received numerous comments regarding SBA's proposed changes to its enforcement procedures. Several comments expressed concern that SBA officials would abuse the authority provided by the enforcement regulations to unfairly penalize or control CDCs. Thus, one comment expressed concern that the regulations ''can be open to wide interpretation by any SBA official at either the local or national level.'' Another comment stated that the enforcement provisions are ''an attempt to give SBA personnel effective operating control of all CDCs'' and that ''[t]hrough the guise of oversight and evaluation SBA officials are attempting to create a web of regulations, which would enable a vindictive official to manipulate every action of a CDC under threat of suspension or termination.''

These comments reflect considerable misunderstanding of the regulations and how SBA typically conducts enforcement actions. SBA's actions reflect numerous layers of careful review and various controls in order to ensure that all facts and relevant issues are considered. Notably, the regulations only authorize the AA/FA (or his or her authorized delegate) to undertake enforcement actions, not numerous agency officials. Moreover, an enforcement action usually begins with a recommendation from the district office, which is signed and approved by various officials. When the recommendation reaches SBA's Headquarters, it is reviewed by a number of officials, as well as attorneys in SBA's Office of General Counsel prior to the initiation of any proposed action. After a notice of proposed action is sent to the program participant, any response from the participant is given considerable analysis by numerous SBA officials and attorneys and a consensus is attained as to whether to proceed with a final enforcement action. This carefully considered process should allay any concerns. Nevertheless, SBA's responsibility for managing the 504 Program requires that the Agency have a wide range of enforcement options available and considerable flexibility in implementing these actions. Moreover, SBA's revision of the enforcement regulations is a direct response to problems that SBA has encountered under the current regulations in dealing with CDCs that have repeatedly failed to comply with SBA rules and regulations or which have willfully failed to comply with SBA efforts to require compliance with regulations and other requirements. Thus, SBA disagrees with those comments that sought to retain the current enforcement regulations without change.

Several comments noted that the Act already prescribes the grounds for enforcement actions to suspend or revoke an ALP CDC or a PCLP CDC's ability to participate in these programs, and, therefore, that the proposed enforcement provisions as they relate to an ALP CDC or PCLP CDC were inconsistent with the statute.

SBA inadvertently consolidated the grounds for such enforcement actions with the general enforcement provisions in the proposed rule, and agrees that the Act sets forth grounds (but not procedures) for the suspension or termination (which the statute refers to as a revocation) of a CDC's authority to act as an ALP CDC or PCLP CDC. Consequently, SBA has made minor revisions to §§ 120.854 to include, verbatim as set forth in the Act, the grounds for such enforcement actions in new paragraphs (b) and (c), and has made conforming technical changes to § 120.855. Although these grounds for enforcement were not included in the proposed rule, the final rule simply incorporates statutory language, which SBA does not have discretion to modify, and makes conforming technical changes to the proposed rule.

In the final rule, all grounds for taking enforcement action against a CDC are combined under one regulation, § 120.854. SBA received some comments that asked whether § 120.854(b) would be applied retroactively. Section 120.180, however, currently provides for prospective application of any new regulations under Part 120, and this regulation has not been amended by this final rule.

Some comments suggested that the word ''knowingly'' be inserted into § 120.854(c) to establish intent. SBA considered this concern but has

declined to adopt it because it is based on a faulty legal premise, and because it would unduly burden the Agency's enforcement authority. Contrary to the assertion that misrepresentation is ''tantamount to civil fraud or deceit'', as several comments contended, the concept of negligent misrepresentation is well established in the law. *See, e.g., First National Bank, Henrietta* v. *SBA,* 429 F.2d 280 (5th Cir. 1970).

SBA emphasizes that the regulation authorizes enforcement action only if a CDC misrepresents or fails to disclose ''material'' information, which would include important information that the CDC would have reason to know the Agency was relying upon in making a decision about a loan or the CDC's participation in the Program. An example of such information would include a CDC's misrepresentation of or failure to disclose information in its annual report to SBA that, if accurately disclosed, would show that the CDC was in violation of SBA rules or regulations. Similarly, a CDC that was seeking authority from SBA to issue a 504 debenture and failed to disclose a significant adverse change in the borrower's financial condition that was known to the CDC would have failed to disclose a material fact.

As to such critical facts, the Agency believes that CDCs have an obligation to exercise diligence to ensure that they provide accurate information to SBA that the CDC knows, or should know, that the Agency is relying upon. Under egregious circumstances, enforcement action may be appropriate if a CDC negligently fails to do so, and SBA needs the flexibility to be able to undertake enforcement action without the unwarranted burden of having to prove that the CDC intended to deceive the Agency. If a CDC's misrepresentation or failure to disclose material was a result of inadvertence, the CDC will have the opportunity to explain this in responding to any proposed enforcement action. In doing so, however, SBA expects that the CDC would discuss the quality control measures it had implemented to prevent transmission of inaccurate or less than thorough information to the Agency. SBA will, thus, consider the ''intent'' of the CDC as part of its determination of whether to proceed with a proposed enforcement action.

A concern was raised regarding the use of the word ''material'' in § 120.854(c) because this term was considered to be too subjective and would ''open the likelihood for abuse and retaliation by the Agency.'' SBA has considered this comment but believes that the term should be retained in the final rule for several reasons. First, use of the word ''material'' is important in that SBA is making it clear that trivial infractions will not trigger an enforcement action under § 120.854(c). Thus, contrary to the comment's suggestion that the word ''material'' could increase the risk of unfounded enforcement actions against a CDC, the intent of the Agency in using this word is just the opposite. At the same time, SBA believes that needed flexibility in applying its 504 Program enforcement procedures is retained through the word ''material''. SBA notes that this term has been employed as longstanding policy with respect to denials of loan guarantees under the 7(a) Program under § 120.524. Thus, SBA believes it is appropriate to retain this word in the final rule.

Several comments were received regarding language in proposed § 120.854(d) that evidence of CDC improper actions could include the CDC's failure to meet one or more of the portfolio benchmarks established by SBA to measure a CDC's portfolio performance. Many of these comments raised similar concerns regarding the accuracy or lack of public adoption of the benchmarks that were discussed above, which SBA has considered and rejected.

Moreover, these comments appear to be based on the erroneous belief that an SBA enforcement action could proceed solely upon a CDC's failure to meet a portfolio benchmark. The regulation provides that benchmark performance is merely supporting evidence that a ''CDC is not performing underwriting, closing, servicing, liquidation, litigation, or other actions with respect to 504 loans in a commercially unreasonable or imprudent manner.'' SBA has made a minor revision to the second sentence of § 120.854(d) to emphasize this regulatory interpretation.

The need to show that a CDC's actions were imprudent or commercially unreasonable would also preclude SBA from being able to bring an enforcement action using the CDC's benchmark performance if the CDC could show that the performance score was directly related to SBA's approval or liquidation of 504 loans, and not the CDC's actions. Thus, SBA disagrees with those comments which asserted that the provision could be used to bring an enforcement action against a CDC for actions that were beyond its control.

In the context of a specific enforcement action that was relying on a CDC's benchmark score as evidence of that CDC's imprudence or commercial unreasonableness, the CDC, having access to the score, as discussed above, and having its own information about the performance of its loan portfolio, would be able to present SBA with arguments that the benchmark score was inaccurate in its opposition to the enforcement action. SBA would carefully consider those comments before proceeding with any enforcement action.

Other comments requested that SBA modify § 120.854(e) to clarify that an agency notification of deficiency to a CDC include a request to take corrective action if appropriate. SBA considered this concern, agrees with the comments, and is modifying the rule accordingly so that an agency notice of deficiency also include a request for corrective action if appropriate. SBA also agrees with, and has modified § 120.854(e) to address, those comments that stated that it would be fair to provide the CDC with a reasonable period of time to cure the deficiency. The Agency disagrees, however, with comments that a specified time for a cure should be provided because SBA needs flexibility in determining the appropriate cure period depending upon the facts of each situation. SBA further disagrees with comments suggesting that a notice of deficiency must describe with specificity the corrective action that is needed rather than simply requiring it to be corrected. Although SBA may suggest the type of corrective action that is needed, it will generally be the CDC, with the knowledge of its own operations and portfolio, that will be in the best position to make the judgment as to how best to correct a deficiency.

Comments objected to proposed language in § 120.854(f) that would permit SBA to initiate enforcement action based upon a CDC's ''pattern of uncooperative behavior or an action that SBA determines is ''deleterious to the 504 program'' or that ''undermines SBA's administration of the 504 program'' or that was ''not consistent with standards of good conduct.'' Generally, the comments expressed concern that these provisions were ambiguous and subject to subjective interpretation. The terms are so broad, one comment opined, so ''as to render it useless in determining what the SBA means and what is expected of the CDC'' and allows SBA ''to decertify a CDC simply for convenience,'' and without just cause or due process.

SBA has considered these comments but believes that the provisions should be retained in order to preserve needed and justifiable flexibility in administering the 504 program, as discussed above. It has been the Agency's experience in dealing with enforcement actions in the past that it

is imperative to have the type of catchall provision embodied by § 120.854(f) in order to have effective management tools available in the event that a program participant is engaging in ''a pattern of uncooperative behavior'' or has taken other action that warrants some enforcement action, but which does not squarely fit within the specific grounds identified in a regulation as a basis for enforcement.

Although SBA retained these provisions, the Agency is sensitive to those comments that CDCs would not be on notice of what behavior was expected by these regulations. SBA believes that the appropriate resolution of these concerns is to provide additional procedural protection to CDCs. Therefore, SBA has added language to § 120.854(f) that would ensure that SBA could only propose enforcement action based on § 120.854(f) after the Agency had: (1) Provided written notice to the CDC explaining why the CDC's actions were uncooperative, not good conduct, or undermined SBA's management of the program and that the CDC's actions could give rise to an enforcement action; and (2) providing the CDC with a reasonable time to cure the deficiency. This change reasonably addresses all of the comments that objected to these provisions.

Several comments objected to the enforcement actions authorized under § 120.855. Thus, concerns were expressed about the language in § 120.855(a) that the AA/FA or his or her delegate's decision to undertake enforcement actions ''in SBA's sole discretion'' would result in enforcement actions that were subjective or selective. SBA disagrees with the suggestion to delete this language because each enforcement case is different and the Agency believes that effective program administration requires maximum flexibility to determine the appropriate enforcement action appropriate for each particular action. SBA also believes that the due process rights that are provided by the regulations, including the review by the SBA OHA (which is discussed further below regarding § 120.856) protects CDCs from arbitrary enforcement actions.

Several comments objected to § 120.855(a)(3) which authorizes SBA to direct a CDC to transfer some or all of its portfolio to another entity. The comments asserted that SBA should provide the CDC with a right to cure any deficiency prior to such a transfer. Directing a CDC to transfer some or all of its portfolio to another entity is an extreme action that would generally only be considered in egregious circumstances. Typically, SBA would provide a CDC with an opportunity to cure a deficiency before the initiation of such an action. SBA, however, disagrees with the proposals to mandate a cure before initiating such an enforcement action because there may be circumstances where the opportunity to cure would not be possible, and SBA's administration of the program would be unnecessarily restricted by a mandatory cure opportunity prior to enforcement. For example, if a CDC was terminated from the program due to regulatory violations, a cure of these violations may not be possible. In such a case, SBA needs the authority to be able to direct the transfer of that CDC's portfolio to another entity without the requirement of providing the CDC with a cure opportunity.

SBA also disagrees with the comments which objected to the Agency's authority to direct the transfer of 504 loans to entities other than SBA or a CDC on the ground that transfer to banks and other for-profit entities was contrary to the public or program's interest. Although it would be SBA's clear preference that 504 loans be transferred to a CDC, there may be occasions where no other responsible CDC exists for such a transfer. SBA requires the flexibility to direct a portfolio transfer in the manner that the Agency believes is in the best interests of the program. Generally, however, it is anticipated that a transfer to an entity other than a CDC would be temporary until another responsible CDC was available.

Many comments objected to § 120.855(a)(4), which allows SBA to direct the Central Servicing Agent (CSA) to suspend payment of fees to a CDC and to direct the CSA to submit those fees to SBA to pay for any financial loss resulting from a CDC's imprudence, commercial unreasonableness or failure to comply with an SBA requirement. SBA has agreed to eliminate the provisions allowing for payment of the fees to the Agency to compensate for financial loss because it would like to study this issue further. SBA, however, has retained in the final rule the language allowing the suspension of fee payments to the CDC as an enforcement tool in the absence of any significant comments on this proposal.

A number of concerns were raised regarding § 120.856, which sets forth procedures for proposing and undertaking enforcement actions, and the affected CDC's due process and appellate rights. As discussed below, SBA has revised this section to address several of the comments the Agency received. These changes have also necessitated a renumbering of the subsections in § 120.856.

Several comments contended that § 120.856(a) should require SBA to provide details of the reasons behind a proposed enforcement action. SBA agrees with this proposal and has added language to make clear that the underlying facts and reasons for the proposed action should be reasonably detailed.

SBA received a number of comments regarding § 120.856(c) [now renumbered as § 120.856(b)], which sets forth the CDC's right to respond to a notice of proposed enforcement action or to a notice of immediate suspension. Several comments requested that the provision should specify that the period for the CDC to respond to a notice should be fixed at 30 days; others felt that the CDC should be given 60 days to respond. SBA disagrees with these comments because the Agency believes that 30 days is a sufficient amount of time, and that the Agency must retain the flexibility to permit a greater or lesser amount of time for a response to accommodate the unique circumstances of each enforcement action. SBA has, however, added language that a CDC may request additional time if it can show that there are compelling reasons why it is not able to respond within the 30-day timeframe.

SBA does, however, agree with those comments that urged that a CDC's 30-day response period should begin to run when a CDC receives the notice of proposed action or immediate suspension. For purposes of determining whether a CDC has timely responded to a notice of a proposed action or immediate suspension, the regulations will make clear that it is presumed that the notice has been received within 5 days of the date of the notice, absent compelling evidence from the CDC to the contrary.

Several comments contended that the regulations should make some or all of the following discovery procedures available to a CDC that receives a notice of a proposed action or immediate suspension: (1) The ability to undertake discovery; (2) the ability to review SBA's complete file; (3) the ability to request and review additional documents; (4) the ability to question SBA's employees; (5) the ability to obtain copies of any documentation that SBA has obtained during the course of its investigation before or after the CDC files its objection; and (6) the ability to obtain information from third parties. Absent these discovery procedures, the comments contended, the CDC would be deprived of the ability to respond meaningfully to the notice. In addition,

the comments urged, a CDC that avails itself of one or more of these discovery procedures should have additional time to respond to the notice of proposed enforcement action or immediate suspension or be able to make additional submissions to SBA beyond the initial objection in opposition to the enforcement action.

The SBA does not believe that these discovery procedures are necessary to provide the CDC with meaningful review or appropriate for the enforcement action set forth in §§ 120.854–120.857. The existing procedures already provide for a meaningful review, in that the CDC will receive a written notice setting forth the proposed enforcement action or immediate suspension and a reasonably detailed description of the underlying facts and reasons for SBA's proposed action or immediate suspension, and will have the opportunity to submit its objections and opposition to that notice. A second review is then undertaken by the Agency prior to the final decision, and the CDC has further relief in seeking review from the OHA and ultimately the courts. The requested discovery procedures will likely serve to delay and frustrate SBA efforts to undertake enforcement necessary for effective program management, and result in considerable additional burden on limited Agency resources in responding to the requested discovery. Indeed, it has been the Agency's experience in attempting enforcement actions in the past that certain CDCs have attempted to repeatedly delay those efforts.

Further, it is SBA's experience that enforcement actions are typically based on documentation and information that is already available or known to the CDC, *e.g.*, loan documentation, the CDC's annual report, or correspondence between the CDC and SBA. Thus, the requested discovery procedures are generally not necessary. Nevertheless, SBA does recognize that if an enforcement action is based on information derived from a third party, *i.e.* a party other than SBA or a CDC, such as a borrower, principles of fairness suggest that that the CDC should be provided with a copy of the relevant documentation or name of the third party in the event the information was oral. SBA recognizes also, however, that there may be occasions where there may be compelling reasons for not disclosing the identity of the third party or copies of the actual documentation, such as privilege or significant impairment of SBA's ability to manage the 504 Program. Therefore, SBA has added a new section § 120.856(g) providing that if an enforcement action is based upon information derived from a third party, SBA's notice of proposed action or immediate suspension will provide copies of documentation received from such third party or the name of the third party in case of oral information unless SBA determines that there are compelling reasons not to provide such information. If compelling reasons exist, SBA will provide a summary of the information it received to the CDC. Finally, SBA disagrees that a regulation is required to allow the CDC to obtain information from these or other third parties because the CDC can pursue such information without the need for a regulation.

Several comments asserted that § 120.856(c) [now renumbered as § 120.856(b)] should provide that a CDC which has received a notice of a proposed action or immediate suspension has the right to request a more definite statement if SBA's reasons for the proposed action were unclear. Inasmuch as SBA would, as a matter of course, respond to any legitimate request for clarification, SBA agrees to amend the regulation to make clear that a CDC may request clarification of a notice. SBA does not, however, agree with those comments that suggested that the regulation should be revised so that such a request for clarification would automatically delay the time for a CDC to respond to the notice. Allowing a CDC the right to postpone its response time based on an alleged inability to understand a notice could allow the CDC to improperly delay the enforcement action by seeking clarification where none was actually needed (and potentially filing repeated requests for clarification), and by waiting until the last possible moment to respond before seeking clarification. In addition, imposing an automatic delay of the CDC's response time would add considerable confusion to the enforcement procedures by creating uncertainty as to the deadline for the CDC's response. Thus, SBA has added language that the Agency ''may'' consider delaying the period for the CDC's response in the event the CDC legitimately seeks clarification or has a compelling basis for needing additional time to respond. The new language would likely preclude a CDC from delaying a request for clarification or additional time or improperly making such requests. If SBA disregarded a legitimate request for clarification or an extension of time and proceeded with a termination action, the CDC would have a right to appeal that decision before the OHA or a federal court.

Several comments requested that section 120.856(d) [now renumbered as § 120.856(c)] should include a deadline for SBA to issue a final decision on a proposed termination action. The offered rationale for this request was that without a deadline, the CDC would be ''in limbo'' for an indefinite period of time and could not pursue its rights before the OHA and the courts. SBA disagrees with these comments, for the most part. If SBA proposes an enforcement action, the CDC would not lose any right or authority until a final decision is made, and, therefore, would not experience any prejudice in the event that SBA did not immediately issue a final decision. Similarly, there is nothing for a CDC to appeal to OHA or the courts until a final decision is rendered. In the case of an immediate suspension under § 120.855(b) [now renumbered as § 120.856(a)(2)], however, the CDC's rights and authority would be affected. Therefore, for those actions, SBA agrees that a deadline should be imposed on the issuance of a final decision to avoid any undue prejudice to the CDC. Therefore, SBA has revised § 120.856(c) to require the Agency to issue a final decision on an immediate suspension within 90 days of receiving the CDC's objection. Procedures have also been added to address this deadline in the event a CDC seeks clarification or additional time. In addition, SBA has clarified that Agency decisions must be in writing in § 120.856(c).

Although SBA did not receive any comments pertaining to § 120.856(e) [now renumbered as § 120.856(d)], the Agency has determined through its own initiative that there is a conflict between this section and § 120.856(f) [now renumbered as § 120.856(e)]. Although proposed § 120.856(e) provided that a decision under that section constitutes the final agency decision, which signifies that there is no further appeal within the agency, proposed § 120.856(f) allowed for an appeal from that section to the OHA. To address this inconsistency, § 120.856(e) has been revised to clarify that it only sets forth a right of appeal and appellate procedures for an appeal from § 120.856(c).

SBA also received a comment from the SBA OHA regarding § 120.856(f) [now renumbered as § 120.856(e)] requiring the OHA review of the appeal of an enforcement action to be consistent with legal precedent developed under the arbitrary or capricious standard of 5 U.S.C. 706 because under OHA regulations this could be construed as requiring that only the SBA Administrative Law Judge would hear such appeals. The Agency intends that Administrative Judges and

the Administrative Law Judge be able to hear appeals and, therefore, has deleted the reference to the statute. Nonetheless, SBA expects that OHA judges will look to legal precedent developed under the arbitrary and capricious standard of the APA in deciding appeals from these enforcement provisions.

Many comments were received that the regulations should allow the SBA Office of Hearings and Appeals to have a de novo review of enforcement actions in § 120.856(e). Several comments contended this review was provided under current regulation (SBA does not interpret the regulation as providing such review, but acknowledges that the current regulation is unclear). One comment stated that the arbitrary and capricious standard imposes such an ''excessive'' burden upon the CDC that ''the decision of the program office would necessarily be affirmed by OHA even if it was obviously wrong.''

SBA has considered but disagrees with these contentions and has retained the original proposed regulations provision that the OHA review is limited to the arbitrary and capricious standard, a standard of review which is well established under the law. As previously noted, the fact that SBA enforcement actions are undertaken with considerable review and deliberation, and that numerous agency officials are involved in the decision, should allay those concerned about arbitrary decisionmaking. However, the decision to take an enforcement action necessarily involves policy judgments about what action is in the best interests of the Agency and the 504 Program. Therefore, SBA does not believe that it is appropriate or in the best interests of the 504 Program for the OHA, which is not a policymaking office and which does not have the familiarity and experience with the 504 Program, to be able to undertake a de novo review and to make policy for the 504 Program.

Further, the arbitrary and capricious standard, although a deferential review, requires that the Agency have a rational and reasonable basis for its decision. If such a basis is lacking, the matter should be remanded back to the Agency for further consideration. A review of the numerous cases which have applied this standard and remanded agency decisions refutes any assertion that the arbitrary and capricious review is merely a rubber stamp of an agency's decision.

Several comments took the position that de novo review by the OHA was required based upon the assertion that procedural due process under the Constitution requires that the decision be made by a ''fair, neutral decision maker.'' These comments, however, did not argue or show a basis for any suggestion that the AA/FA was not a fair, neutral decision maker. Moreover, to the extent these comments assert that an appeal of an agency decision to an independent office of the agency is required by constitutional due process, those comments are simply mistaken. SBA could, and, indeed, has in numerous regulations, provided that the decision by the relevant agency official is the final agency action, without providing any right of appeal to the OHA. OHA review of enforcement actions is not a right, but an accommodation that SBA has chosen to provide to CDCs in order to improve the fairness of the enforcement procedures.

Several comments contended that the regulations should allow a CDC to raise arguments with the OHA that it had not made to the Agency in responding to a proposed enforcement action, and that CDCs should have a right of discovery or to subpoena third parties in the OHA to add information to the record of the agency's decision. One comment's justification for allowing new arguments to be raised before the OHA was that ''the CDC may easily forget an important matter and not raise it or make a submission * * * without relying on counsel.''

SBA also considered but is not persuaded by these comments. If the CDC provided the OHA with arguments or information obtained through discovery in the OHA that were not considered by the Agency, the OHA's review would not merely evaluate whether the Agency's decision was supported by the administrative record, but would necessarily entail a de novo review of the underlying matter. As stated above, SBA believes such review is inappropriate. Additionally, a CDC that is faced with a proposed enforcement action or immediate suspension would be best advised to make sure that it diligently provides all relevant information to the Agency and consults with counsel to the extent it deems such consultation to be appropriate.

Nevertheless, SBA does agree that a CDC that can show that it was unable to present facts or an argument to the AA/FA due to compelling reasons beyond its control, and that it has been prejudiced by this inability, can request that the OHA remand the matter back to the AA/FA for further consideration. This procedure is set forth in new language that has been added to § 120.856(e). Similar language has been added to newly renumbered § 120.856(b) with respect to a CDC's objection to a notice of a proposed action or immediate suspension, with conforming language added to § 120.856(e)(3).

SBA also has added language to § 120.856(e) that if the OHA decides that SBA's decision was arbitrary, capricious or contrary to law, the OHA must remand the matter to the AA/FA or the deciding official for further consideration. Although this was clearly implied in the proposed rule, it was not explicitly stated and so SBA has added this language to the final rule for clarification.

As discussed above with respect to § 120.810 and elsewhere, SBA has deleted language from the proposed regulations to the effect that the procedures in §§ 120.854 to 120.856 do not apply to those sections. SBA has added a new paragraph 120.856(f) which incorporates the concept of the deleted language to specify that the procedures in § 120.856 only apply to actions undertaken pursuant to § 120.855.

Section 120.861, job creation or retention, is revised (see discussion of revisions to § 120.829 for a description of the changes to the job requirement criteria and the comments received). The change in the criteria will be published in a **Federal Register** notice from time to time.

Section 120.862, other economic development objective, includes two technical changes. The first is the Agency-wide replacement of ''SIC'' codes with ''NAICS'' codes when identifying the types of small businesses eligible to receive SBA assistance. The second is to correct the cross-reference to the regulation that describes a minority for purposes of the public policy goal of assisting minority-owned businesses. The changes also reflect the statutory changes to section 501(d) of the Act, which added women-owned and veteran-owned businesses to the public policy goals.

Section 120.870, leasing project property, eliminates references to 504 project property being leased by the CDC to the borrower. Comments received suggested revising SBA's rules regarding leasing to be more flexible. SBA considered these comments to be beyond the scope of the proposed rule. Therefore, SBA is adopting § 120.870 as proposed.

SBA is changing the heading of § 120.871 to make the form consistent with other section headings.

Section 120.880, basic eligibility requirements, simplifies the regulation by replacing the actual size standards with a cross-reference to the size standard regulation. As the size standard regulations change, so will this

regulation without requiring it to be re-written. Comments received were supportive of this change. Therefore, SBA is adopting § 120.880 as proposed.

Section 120.882, eligible project costs for 504 loans, clarifies eligible costs that may be included in 504 project costs. SBA received some comments on this regulation requesting clarification. For example, previously the regulation included accounting fees as a professional fee, but the proposed rule does not. SBA deliberately proposed to remove accounting fees because even though the regulation stated that only fees attributable to the project were to be included, borrowers were submitting as accounting costs fees charged by their accountant to prepare financial statements, which are a cost of doing business, not a project-related cost. The final rule retains this charge. Commenters were also concerned that certain items in the proposed rule were not project-related fees, such as hazard and flood insurance. SBA considered these concerns and agreed. Therefore, SBA is deleting hazard and flood insurance from the list of eligible project costs in § 120.822. Recording fees are eligible project costs, and are already covered in § 120.882(a), and therefore do not appear in § 120.882(c) in the final rule. Other comments were concerned that such fees as permit fees and utility hook-up fees were not included. SBA believes such fees are already covered by § 120.882(a), (b), and (d), which SBA did not propose to change. As a result of comments, SBA also deleted the reference to § 120.971(a)(2) which limits legal fees associated with a 504 loan and debenture closing. SBA was concerned that the limitation might be construed as also applying to legal fees that are part of eligible project costs. This rule adopts section § 120.882 as proposed except as discussed.

Section 120.883, eligible administrative costs for 504 loans, clarifies eligible administrative costs that may be paid from the proceeds of the 504 Loan and debenture. SBA received some comments on this proposed regulation that sought clarification. The comments objected to what was perceived as a stricter interpretation of eligible administrative costs for 504 loans than previously permitted. SBA intends this result, because administrative costs must be very limited in order to protect the government's lien position in the collateral. SBA's lien generally is in a second lien position behind a larger first lien securing the third party loan. The Act requires the borrower to contribute at least 10 percent towards the project costs (see section 502(3)(c) of the Act) . The calculation of the amount of SBA's share of the financing (up to a maximum of 40 percent) as well as the borrower's contribution is based on the total amount of project costs. Administrative costs were designed to permit the borrower to finance a limited number of specific fees above the project costs as part of the debenture financing that receives SBA's 100 percent guarantee. Every dollar of administrative cost that is included in the debenture increases SBA's exposure on the debenture and erodes the equity cushion provided by the borrower in the collateral. Therefore, it is SBA's intention that only the specific fees listed in the regulation be financed by the debenture and receive SBA's guaranty protection. Fees that are not eligible project costs or eligible administrative costs must be treated separately as a cost of doing business by the borrower. Accordingly, § 120.883 in the final rule refers to all of § 120.882, not just to § 120.882(c), to clarify that none of the fees that qualify as eligible project costs under § 120.882 may be included as administrative costs included in the debenture. This rule adopts § 120.883 as it was published in the proposed rule except as discussed.

Section 120.892 is revised to require a 504 loan borrower to provide to the CDC current financial statements within 120 days of 504 loan closing, instead of within 90 days. Comments received were supportive of this change. This rule adopts § 120.892 as proposed.

SBA is changing the headings of §§ 120.900 and 120.910 to make their form consistent with the other section headings in Subpart H.

Section 120.911, land contributions, makes a technical correction to the regulation by deleting the reference to CDCs. CDCs do not contribute land for a 504 loan.

Section 120.913, limitations on any SBIC contributions, clarifies the heading, and adds a cross-reference and clarifies the section.

Section 120.923, policies on subordination, changes the section heading and consolidates the current §§ 120.923 and 120.924.

Section 120.925, preferences, adds a cross-reference to another SBA regulation governing preferences.

Section 120.926, referral fee, modifies the current language by adding ''reasonable'' in describing the referral fee that a CDC may charge a third party lender. The changes also emphasize that neither the lender nor the CDC can charge this fee to the borrower. SBA received one comment that suggested that a CDC be permitted to charge a referral fee to a borrower. The commenter believes that it is in the best interest of a potential borrower that requires additional help in accessing capital to charge this fee directly to the borrowers. The commenter also stated that the inability to charge the fee to a borrower would be a disincentive to the CDC to find a lender for difficult or rural-based loans. SBA considered this comment but was not persuaded. SBA has observed that the fees permitted to be charged by a CDC to a borrower have generally been sufficient to reimburse a CDC for its services related to all aspects of a 504 financing. With the increase in choice among CDCs for a potential 504 borrower as a result of this rule, SBA believes the fees permitted to be charged to a borrower are sufficient incentive to CDCs to make financing available to all eligible and credit-worthy 504 borrowers.

Section 120.930, amount, eliminates the requirement that SBA must approve 504 loans between $25,000 and $50,000 on an exception basis. SBA does not believe that it ever has declined such a request. Comments received on §§ 120.900–120.930 were generally supportive. SBA is adopting § 120.900, § 120.910, § 120.911, § 120.913, § 120.923, § 120.925, § 120.926, and § 120.930 as they were proposed.

Section 120.931, 504 lending limits, increases the dollar amounts to reflect the changes to section 502(2) of the Act that became effective December 21, 2000. Comments received suggested that this section be adjusted automatically to reflect any changes established by Congress. SBA considered these comments but believes the suggestions are beyond the scope of the proposed rule. SBA is adopting § 120.931 as proposed.

Section 120.933, maturity, creates flexibility in debenture maturities. This will permit SBA to consider other maturities besides 10 and 20 years at some future date. SBA received comments regarding the proposed change that expressed concern regarding SBA's proposal to permit additional maturities. The comments suggested that this would ''cause chaos in the funding markets'' or ''wreak havoc.'' SBA considered these comments and strongly disagrees. SBA notes that the home mortgage industry has expanded the number of maturities offered substantially to better serve the needs of home loan borrowers. While SBA has no immediate plans to make changes to the 10 and 20-year maturities now used, SBA believes it is important that the Agency has this flexibility in order to serve the changing needs of the small business community. Therefore, SBA is publishing the regulation as proposed to

permit SBA greater flexibility in meeting the needs of the marketplace.

Section 120.934, collateral, clarifies the paragraph by rearranging and re-wording the sentences.

Section 120.935, changes the heading.

Section 120.936, subordination to CDC, is deleted. SBA believes that this regulation is a holdover from the former 501 and 502 programs. SBA knows of no instance when a CDC has requested a subordination on its 504 loans. Comments received were supportive of the changes to §§ 120.934–120.936. SBA adopts §§ 120.934, 120.935, and 120.936 as they were published in the proposed rule.

Section 120.960, responsibility for closing, describes the circumstances under which SBA can decline to close a debenture or cancel its guarantee of the debenture prior to sale. Several comments received suggested that the regulation gives too much unilateral authority to SBA. While the commenters did not suggest that SBA eliminate its right to review the debenture closing before the debenture sale, they did suggest that SBA would have too much discretion under this regulation as proposed, to decline to approve a debenture for sale. SBA considered these concerns and agrees that several changes are needed, which will make this section more consistent with SBA's long-standing practice in place for SBA-guaranteed 7(a) loans but without eliminating SBA's review of 504 loan and debenture closing prior to debenture sale. SBA has not proposed to, and does not in the final rule eliminate, this prior review by SBA, because of the significant differences between the 504 Program and the 7(a) program with regard to SBA's practice for determining SBA's liability under its guaranty. SBA believes it must have the discretion to take the actions set forth in § 120.960(c) in order to adequately protect SBA's guaranty of the debenture and minimize the credit risk to the entire 504 loan portfolio.

Section 120.524 describes the bases upon which SBA may be released from liability on its guaranty for 7(a) loans. SBA reviews the 7(a) lender's documentation after the 7(a) loan is closed and disbursed and usually only after a default. The purpose of the review is to determine whether SBA should honor its guaranty by granting a purchase request, seek a reduction in SBA's guaranty liability, deny liability in full or in part on SBA's guaranty, or seek recovery from the lender if the SBA has already purchased the loan from the secondary market holder or from the lender itself. The purchase review is a process that serves to minimize an erroneous payment by SBA, by ensuring that SBA purchases only those loans which were originated, closed, serviced and liquidated in accordance with the loan authorization, prudent lending standards, and SBA regulations and other requirements.

As discussed under § 120.848, currently there is no such purchase review process for 504 loans; SBA simply honors its guaranty to the debenture holder and generally does not seek recovery against the CDC for SBA's loss under the guaranty (although SBA has such regulatory authority). If a CDC were to close a 504 loan and debenture without SBA review, then SBA likely would need to create a new review process, to take place after SBA's purchase of the debenture upon default on the 504 loan, to ensure that the CDC had closed the 504 loan in accordance with the loan authorization, prudent lending standards and SBA regulations and other requirements, and if a deficiency were discovered, SBA would need to determine the extent to which SBA should seek recovery from the CDC for SBA's loss under its guaranty. SBA does not intend to implement such a process in the 504 Program at this time. For these reasons and based on recommendations from commenters, in the final rule SBA added the word ''materially'' to § 120.960(c)(1), to make it consistent with § 120.524(a)(1); and changed the phrase ''a material adverse change'' to ''an unremedied material adverse change'' to § 120.960(c)(7), to make it consistent with the terms of the 504 loan authorization. Other than these changes, § 120.960 is implemented as proposed.

Section 120.970, servicing of 504 loans and debentures, clarifies the regulation regarding a CDC's responsibility in servicing a 504 loan. Comments received on this regulation suggested that SBA establish a new borrower fee identified as a ''default servicing fee.'' According to the commenters, the borrower would incur the fee if the borrower failed to comply with certain requirements such as submitting financial statements. Since the proposed rule did not propose this new fee to a borrower, this suggestion is beyond the scope of the proposed rule. Comments also suggested that § 120.970(c) was confusing because it seemed to suggest that the borrower, not the CDC, was responsible for filing renewals and extensions of security interests. SBA considered these comments and concurs. SBA has modified the rule to clarify that the CDC is responsible for filing renewals and extensions. This rule adopts § 120.970 as it was published in the proposed rule except as discussed.

Section 120.971, allowable fees paid by borrower, clarifies the language describing the loan closing fees that a CDC may charge. Comments received suggested a change to permit CDCs the ability to increase the servicing fee charged to an uncooperative borrower for issues such as not providing required statements of proof of insurance, evidence of tax payments or financial statements. SBA considered these comments but believe they are beyond the scope of this rulemaking. This rule adopts § 120.971 as proposed.

Section 120.972, third-party lender participation fee and CDC fee, revises the heading, deletes the language ''from the Third Party Lender'' from paragraph (a), and slightly clarifies paragraph (b). SBA may accept the third party lender participation fee from the third party lender, the 504 borrower, or the CDC. This final rule implements § 120.972 as proposed.

SBA is removing §§ 120.980–120.984. Comments received were supportive of these changes. This rule removes §§ 120.980–120.984.

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

Executive Order 13132: For the purposes of Executive Order 13132, the SBA determined that this rule has no federalism implications warranting preparation of a federalism assessment.

Executive Order 12988: For purposes of Executive Order 12988, Civil Justice Reform, SBA determined that this rule is drafted, to the extent practicable, in accordance with the standards set forth in paragraph 3 of that Order.

Executive Order 12866: The Office of Management and Budget (OMB) has determined that this rule constitutes a significant regulatory action under Executive Order 12866, Regulatory Planning and Review. SBA received no comments regarding the Executive Order from the public. SBA believes there is a need for this regulatory action for the reasons stated in the preamble above. SBA believes these regulatory changes will improve 504 Program delivery to small business customers to increase customer choice of service; increase third party lender choice of CDCs; facilitate the formation of new CDCs; facilitate the expansion of existing CDCs; and increase the number of CDCs able to take advantage of special initiatives for rural areas. By allowing market-driven forces to determine availability of 504 Program

service, small businesses will have greater opportunity to negotiate the best total financing package, including fees, as well as receive increased service by CDCs. In addition, the 504 Program will be more responsive to changes in market conditions. SBA believes that there are no viable alternatives to these changes that would produce similar positive results without imposing an additional burden on the SBA or the public.

In Fiscal Year (FY) 2002, OMB developed the Program Assessment Rating Tool (PART) to establish a systematic, consistent process for rating the performance of programs across the Federal government. The 504 Program was evaluated under the PART criteria in FY 2002. The PART review revealed that the SBA needs to increase the availability of CDCs within the 504 Program to improve customer access to loans. Additionally, increasing the availability of CDCs will enable borrowers to determine which of the SBA's loan programs best meet their needs. The SBA expects that this rule will address that recommendation from OMB. The OMB PART review on this program can be found at *http://www.whitehouse.gov/omb/budget/fy2004/pma/certifieddevelopment.pdf.*

The SBA does not have sufficient data to establish a baseline in order to measure the costs and benefits of this rule on the affected public. However, the SBA has data on the cost to SBA of the 504 Program. In FY2002, the cost of the 504 Program to SBA was approximately $15 million. The majority of the cost of the Program, 82 percent or $12.6 million, was for the cost of the field office staff support that reviewed and approved loan applications and conducted marketing and outreach to generate new loans. The cost of the 504 Program to the SBA also includes the cost of reviewing and analyzing CDC requests to expand their areas of operations by SBA's field office and Headquarters staff. The SBA would expect this cost to decline substantially as a result of this final rule because it permits all CDCs to operate at least throughout their State of incorporation. Other data on costs of the program can be found at *http://www.sba.gov/aboutsba/budgetplans.html.* Relevant information is provided on pages 23–24 of SBA's Budget Request and Performance Plan: Congressional Submission Fiscal Year 2004 and on pages 69–71 of SBA's Performance and Accountability Report Fiscal Year 2002.

Regulatory Flexibility Act: This rule directly affects all CDCs, of which there are approximately 270. SBA has determined that CDCs fall under the size standard for NAICS 522298, All Other Nondepository Credit Intermediaries. The size standard is $6 million in average annual receipts. SBA estimates that at least 95 percent of the CDCs do not exceed this size standard and are therefore considered small entities by this definition. Thus, SBA has determined that this rule will have an impact on a substantial number of small entities.

Even though SBA has determined that this rule will have an impact on a substantial number of small entities, SBA has determined that the impact will not be significant. SBA understands the concerns raised by some comments received that suggested that this rule may have a significant impact on many small and rural CDCs. Some comments expressed the concern that increased competition and reliance on market forces could lead to more decertifications of small and rural CDCs. Other commenters stated that small CDCs will not be able to compete in the new competitive environment this rule would create. For example, one stated concern is that larger CDCs would have an unfair advantage, and that small CDCs would be hurt by the new competition because many small CDCs will not have the resources necessary to access more profitable markets beyond their current area of operations while larger CDCs will access the more profitable markets of small and rural CDCs.

SBA considered these comments but continues to believe that the rule is not significant. SBA believes that the effect of this rule will be first to ''level the playing field'' by allowing CDCs more flexibility to choose the optimal area of operations within their State of incorporation. Currently, each CDC has a specific area of operations that is approved by SBA. The typical area of operations is several counties within the CDC's State of incorporation. If a CDC wishes to apply to expand into neighboring counties, it can only do so if those counties are available. A county is available to a new CDC or a CDC requesting to expand its area of operations if the CDC(s) that include that county in its area of operations is not meeting a threshold of one 504 approval per year per 100,000 population averaged over two years. If the existing CDC is meeting this threshold of activity, both an applicant wishing to become a CDC and a CDC wishing to expand its area of operations is barred from including that county in their request. This rule eliminates that threshold and permits all CDCs the opportunity to operate anywhere in their State of incorporation. This would allow CDCs in less lucrative areas to have access to the greater opportunities available in the more lucrative areas.

SBA believes that some CDCs will choose to continue to operate in those counties they presently operate in while others will choose to expand their market area into neighboring counties or throughout the State. It has been SBA's experience with CDCs that are permitted to compete with other CDCs in the same market area, that the market of eligible 504 projects itself expands, resulting in a benefit for the affected CDCs as well as a benefit to small business borrowers. A recent example was the approval of a large CDC into a small CDC's area of operations in the Midwest. As a consequence, a county in which there had been no 504 loan activity the prior year generated two 504 loans for the small CDC and three 504 loans for the large CDC.

SBA also believes that smaller, rural CDCs will derive a similar benefit by having a greater opportunity to meet the required 504 loan activity level. Since 1993, SBA has had to revoke certifications from more than 100 CDCs and transfer their 504 loan portfolios and fees to other, active CDCs due to their failure to meet the required 504 activity level of two 504 loan approvals per year averaged over two years. Most of these CDCs have been located in rural areas where there are a limited number of potential 504 projects. Competition with other, larger CDCs was not the reason why these rural CDCs could not meet the required loan volume. There was simply a lack of 504-eligible projects in the geographic area. This rule enables those small, rural CDCs the opportunity to expand their market area by doing projects in more populous areas, resulting in their more easily meeting the 504 loan activity level. The result will be that these CDCs will remain in the program and continue to be available locally to small businesses in the rural areas. At the same time, those CDCs that currently have exclusive areas that include populous urban areas resulting in substantial 504 loan activity may seek to expand their market areas into the less lucrative rural areas which will increase awareness of the program overall which may in turn be beneficial to the small, rural CDCs.

Finally, as stated previously, it has been SBA's experience that the more CDCs that market the 504 program in a particular area, the higher the 504 loan volume in that area. SBA believes that this is due to the additional marketing initiatives by the CDCs which creates an increased awareness of the 504 Program among the local lending community and improves their willingness to participate because they have a choice. SBA

believes this increased awareness in the 504 Program can benefit small and rural CDCs even if they do not have the resources to increase their own marketing and outreach efforts. SBA also believes having multiple CDCs in the area improves the service provided by the CDCs, which also makes the 504 Program more useful to the local lending communities. As more and more lenders successfully use the program, they discuss it and provide information about it to other lenders which increases the impact of the marketing efforts of all CDCs serving the area. A similar phenomenon occurred in the lending industry. Over the years, lenders participating in SBA's 7(a) program have always been willing to come to lenders' meetings to describe their activity with other lenders. They do this because they recognize that as more people are aware of the program, the size of the market will increase, resulting in more overall loan activity for the lender.

This rule also permits new CDCs the opportunity to market in areas that may produce more 504 loans sooner. This in turn should permit the new CDC the ability to reach a breakeven point sooner in its operations and continue to meet the required 504 activity of two 504 approvals per year. Currently it is estimated that it takes a CDC at least two years at a cost of $200,000 or more to reach the 504 activity level where the 504 fee income covers the CDC's expenses. Very few of the new CDCs that SBA has certified in recent years have been able to remain viable. Allowing CDCs to market in multiple areas increases their ability to obtain customers.

To summarize, the expected results of this final rule are that CDCs (and existing and future 504 loan borrowers) will benefit because small, rural CDCs that currently struggle to meet the volume requirement will be retained, awareness of the 504 program among lenders will increase, new CDCs will have a greater opportunity to succeed, and borrowers will have more choice among CDCs.

In addition, SBA expects this rule will result in a reduction in the overall paperwork burden for CDCs since CDCs will no longer have to apply to SBA to expand their area of operations within their State of incorporation. SBA received and approved approximately 11 expansion requests during 2002. All were for CDCs requesting expansions into neighboring counties within the CDC's State of incorporation. The burden hours for a new CDC or a CDC wishing to expand to complete an application is estimated to be 10 hours. None of the applications for an expansion would have been necessary under this rule. In addition, applicants requesting to become CDCs also will be permitted to establish their optimal area of operations within their State of incorporation without being excluded from areas that currently have one or more CDCs. The SBA receives one or two applications to become a CDC per year. The burden hours for an application will be reduced by approximately one hour due to the changes in the general membership requirements that will allow an applicant more flexibility in meeting this requirement. The SBA believes that the economic impact of the reduction in paperwork, if any, will be minimal to small entities.

SBA also received comments expressing concern about the enforcement provisions and the perceived increased authority SBA would derive from the provisions. SBA disagrees that the new enforcement provisions will result in significant economic impact. Although SBA had proposed allowing the use of fees that CDCs receive to compensate SBA from financial losses resulting from improper CDC conduct, the final rule deletes this provision. SBA also has a history of fair and evenhanded use of enforcement authority in all of our lending, procurement, grant, and other assistance programs. CDCs are protected from unfair or biased enforcement of the rules through the notice and appeal procedures in the regulations.

Accordingly, SBA determines that this rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601–612.

Paperwork Reduction Act: For the purposes of the Paperwork Reduction Act, 44 U.S.C. Chapter 35, SBA has submitted two different reporting requirements to OMB for review: (1) the PCLP application and (2) the PCLP Loan Loss Reserve Fund (LLRF) reporting requirements. SBA received no comments from the public regarding these two information collections. SBA makes no changes to either of these information collections in this rule.

A. Application

The PCLP application form is for the use of the 26 PCLP CDCs as provided in § 120.848(d). The application will allow SBA to collect the information it needs from the PCLP in order to extensively analyze the borrower's financing proposal, including information on the borrower's personal and business financial statements, cash flow projections, and related information to support an eligibility determination. Analysis of the application is activities are designed to control and limit the risk associated with the 504 Program and SBA's guaranty, but they do require significant SBA resources. SBA estimates the burden of this collection of information as follows: A PCLP CDC will complete these forms for each PCLP loan it processes. SBA estimates that the time needed to complete this collection is 45 minutes. SBA estimates that the cost to complete this collection will be approximately $20 per hour due to the clerical nature of most of the completion. Total estimated aggregated burden per annum is estimated to be approximately 700 hours per annum costing an aggregated $14,000 per year.

B. LLRF Compliance Information

The LLRF Compliance form is for the use of the 26 PCLP CDCs as provided in § 120.847(f). The LLRF compliance information will document the PCLP CDC's meeting of the LLRF deposit requirements. This will require the PCLP CDC to keep track of the face amount of each PCLP debenture and then determine and record the amount that must be contributed into its LLRF. SBA estimates the burden of this collection of information one hour per PCLP debenture. PCLP debenture volume will vary significantly among participants. We expect that few PCLP CDCs will issue more than 50 PCLP debentures annually. That would mean an aggregate burden of no more than 50 hours per year. SBA estimates that the added cost would be minimal, because existing PCLP CDC support staff and ordinary bank records will cover the labor costs. At an estimate of $10 per hour, the reporting requirements would not likely exceed $500 per year for any PCLP CDC.

SBA created these information collections with the goal of collecting only the necessary information needed to successfully and efficiently operate the CDC program with minimal burden to the public.

List of Subjects in 13 CFR Part 120

Loan Programs—business, Reporting and recordkeeping requirements, Small business.

■ For the reasons discussed in the preamble, SBA is amending 13 CFR part 120 as follows:

PART 120—BUSINESS LOANS

■ 1. The authority citation for part 120 continues to read as follows:

Authority: 15 U.S.C. 634(b)(6), 636(a) and (h), 696(3) and 697(a)(2).

■ 2. Amend § 120.10 by adding a definition of ''SOP'' to read as follows:

* * * * *

SOPs are SBA Standard Operating Procedures, as issued and revised by SBA from time to time.

Subpart A—Policies Applying to All Business Loans

■ 3. Revise the first sentence of the introductory text of § 120.140 to read as follows:

§ 120.140 What ethical requirements apply to participants?

Lenders, Intermediaries, and CDCs (in this section, collectively referred to as ''Participants''), must act ethically and exhibit good character. * * *

* * * * *

Subpart H—Development Company Loan Program (504)

■ 4. Revise the heading of § 120.800 to read as follows:

§ 120.800 The purpose of the 504 program.

* * * * *

■ 5. Revise the heading of § 120.801 to read as follows:

§ 120.801 How a 504 Project is financed.

* * * * *

■ 6. Amend § 120.802 by removing the definition of ''Associate Development Company''; revising the definition of ''Area of Operations''; adding definitions of ''Designated Attorney'', ''Lead SBA Office'', and ''Priority CDC''; and revising the first sentence of the definition of ''Local Economic Area'', to read as follows:

§ 120.802 Definitions.

* * * * *

Area of Operations is the geographic area where SBA has approved a CDC's request to provide 504 program services to small businesses on a permanent basis. The minimum Area of Operations is the State in which the CDC is incorporated.

* * * * *

Designated Attorney is the CDC closing attorney that SBA has approved to close loans under an expedited closing process for a Priority CDC.

* * * * *

Lead SBA Office is the SBA District Office designated by SBA as the primary liaison between SBA and a CDC and with responsibility for managing SBA's relationship with that CDC.

Local Economic Area is an area, as determined by SBA, that is in a State other than the State in which an existing CDC (or an applicant applying to become a CDC) is incorporated, is contiguous to the CDC's existing Area of Operations (or the applicant's proposed Area of Operations) of its State of incorporation, and is a part of a local trade area that is contiguous to the CDC's Area of Operations (or applicant's proposed Area of Operations) of its State of incorporation. * * *

* * * * *

Priority CDC is a CDC certified to participate on a permanent basis in the 504 program (see § 120.812) that SBA has approved to participate in an expedited 504 loan and Debenture closing process.

* * * * *

■ 7. Revise § 120.810 to read as follows:

§ 120.810 Applications for certification as a CDC.

(a) An applicant for certification as a CDC must apply to the SBA District Office serving the jurisdiction in which the applicant has or proposes to locate its headquarters (see § 101.103 of this chapter).

(b) The applicant must apply for an Area of Operations. The applicant's proposed Area of Operations must include the entire State in which the applicant is incorporated, and may include Local Economic Areas. An applicant may not apply to cover an area as a Multi-State CDC.

(c) The applicant must demonstrate that it satisfies the CDC certification and operational requirements in §§ 120.820, and 120.822 through 120.824. The applicant also must include an operating budget, approved by the applicant's Board of Directors, which demonstrates the required financial ability (as described in § 120.825), and a plan to meet CDC operational requirements (without specializing in a particular industry) in §§ 120.821, and 120.826 through 120.830.

(d) The District Office will forward the application and its recommendation to the AA/FA, who will make the final decision. SBA will notify the CDC in writing of its decision, and, if the petition is declined, the reasons for the decision.

§ 120.811 [Removed]

■ 8. Remove § 120.811.

■ 9. Revise § 120.812 to read as follows:

§ 120.812 Probationary period for newly certified CDCs.

(a) Newly certified CDCs will be on probation for a period of two years from the date of certification, at the end of which the CDC must petition the Lead SBA Office for:

(1) Permanent CDC status; or

(2) A single, one-year extension of probation.

(b) SBA will consider the failure to file a petition before the end of the probationary period as a withdrawal from the 504 program. If the CDC elects withdrawal, SBA will direct the CDC to transfer all funded and/or approved loans to another CDC, SBA, or another servicer approved by SBA.

(c) The Lead SBA Office will send the petition and its recommendation to the AA/FA, who will make the final decision. SBA will determine permanent CDC status or an extension of probation, in part, based upon the CDC's compliance with the certification and operational requirements in §§ 120.820 through 120.830.

(d) SBA will notify the CDC in writing of its decision, and, if the petition is declined, the reasons for the decision.

■ 10. Revise § 120.820 to read as follows:

§ 120.820 CDC non-profit status and good standing.

A CDC must be a non-profit corporation, except that for-profit CDCs certified by SBA prior to January 1, 1987 may retain their certifications. An SBIC may not become a CDC. A CDC must be in good standing based upon the following criteria:

(a) In good standing in the State in which the CDC is incorporated and any other State in which the CDC conducts business.

(b) In compliance with all laws, including taxation requirements, in the State in which the CDC is incorporated and any other State in which the CDC conducts business.

■ 11. Revise § 120.821 to read as follows:

§ 120.821 CDC Area of Operations.

A CDC must operate only within its designated Area of Operations approved by SBA except as provided in § 120.839.

■ 12. Revise § 120.822 to read as follows:

§ 120.822 CDC membership.

(a) *CDC Membership.* A CDC must have at least 25 members (or stockholders for for-profit CDCs approved prior to January 1, 1987). The CDC membership must meet annually. No person or entity can own or control more than 10 percent of the CDC's voting membership (or stock). No employee or staff of the CDC can qualify as a member of the CDC for the purpose of meeting the membership requirements. The CDC membership must include representatives from all the groups listed in paragraph (b) of this section.

(b) *Membership groups.* Members must be responsible for actively supporting economic development in the Area of Operations and must be from one of the following groups:

(1) Government organizations responsible for economic development in the Area of Operations;

(2) Financial institutions that provide commercial long term fixed asset financing in the Area of Operations;

(3) Community organizations dedicated to economic development in the Area of Operations such as chambers of commerce, foundations, trade associations, colleges, universities, or small business development centers (as defined in section 21(a)(1) of the Act, 15 U.S.C. 648(a)(1)); and

(4) Businesses in the Area of Operations.

(c) A CDC that is incorporated in one State and is operating as a Multi-State CDC in another State must meet the membership requirements for each State.

■ 13. Amend § 120.823 by revising paragraph (b) to read as follows:

§ 120.823 CDC Board of Directors.

* * * * *

(b) If a CDC is incorporated in one State and is approved as a Multi-State CDC to operate in another State, the CDC must have a Loan Committee for each State.

■ 14. Amend § 120.824 by revising the third sentence in the introductory text and paragraph (a) to read as follows:

§ 120.824 Professional management and staff.

* * * CDCs may obtain, under written contract, management, marketing, packaging, processing, closing, servicing or liquidation services provided by qualified individuals and entities under the following circumstances:

(a) The CDC must have at least one salaried professional employee that is employed directly (not a contractor or an Associate of a contractor) full-time to manage the CDC. The CDC manager must be hired by the CDC's board of directors and subject to termination only by the board. A CDC may petition SBA to waive the requirement of the manager being employed directly if:

(1) Another non-profit entity that has the economic development of the CDC's Area of Operations as one of its principal activities will contribute the management of the CDC, and the management contributed by the other entity also may work on and operate that entity's economic development programs, but must be available to small businesses interested in the 504 program and to 504 loan borrowers during regular business hours; or

(2) The CDC petitioning SBA for such waiver is rural; has insufficient loan volume to justify having management employed directly by the CDC; and has contracted with another CDC located in the same general area to provide the management.

* * * * *

■ 15. Revise § 120.826 to read as follows:

§ 120.826 Basic requirements for operating a CDC.

A CDC must operate in accordance with all 504 program requirements imposed by statute, regulation, SOPs, SBA policy and procedural notices, loan authorizations, Debentures, and agreements between the CDC and SBA. In its Area of Operations, a CDC must market the 504 program, package and process 504 loan applications, close and service 504 loans, and if authorized by SBA, liquidate and litigate 504 loans. It must supply to SBA current and accurate information about all certification and operational requirements, and maintain the records and submit the reports required by SBA.

■ 16. Revise § 120.827 to read as follows:

§ 120.827 Other services a CDC may provide to small businesses.

A CDC may provide a small business with assistance unrelated to the 504 loan program as long as the CDC does not make such assistance a condition of the CDC accepting from that small business an application for a 504 loan. An example of other services a CDC may provide is assisting a small business in applying for a 7(a) loan (as described in § 120.2). A CDC is subject to part 103 of this chapter when providing such assistance.

■ 17. Revise § 120.828 to read as follows:

§ 120.828 Minimum level of 504 loan activity and restrictions on portfolio concentrations.

(a) A CDC is required to receive SBA approval of at least four 504 loan approvals during two consecutive fiscal years.

(b) A CDC's 504 loan portfolio must be diversified by business sector.

■ 18. Amend § 120.829 by revising paragraph (a) to read as follows:

§ 120.829 Job Opportunity average a CDC must maintain.

(a) A CDC's portfolio must maintain a minimum average of one Job Opportunity per an amount of 504 loan funding that will be specified by SBA from time to time in a **Federal Register** notice. Such Job Opportunity average remains in effect until changed by subsequent **Federal Register** publication. A CDC is permitted two years from its certification date to meet this average.

* * * * *

■ 19. Revise paragraphs (a) and (b) of, and add a new paragraph (g) to § 120.830 to read as follows:

§ 120.830 Reports a CDC must submit.

* * * * *

(a) An annual report within 180 days after the end of the CDC's fiscal year (to include financial statements of the CDC and any affiliates or subsidiaries of the CDC), and such interim reports as SBA may require;

(b) For each new associate and staff, a Statement of Personal History (for use by non-bank lenders and CDCs) and other information required by SBA;

* * * * *

(g) Other reports as required by SBA.

■ 20. Revise § 120.835 to read as follows:

§ 120.835 Application to expand an Area of Operations.

(a) *General.* A CDC that has been certified to participate in the 504 program may apply to expand its Area of Operations if it meets all requirements to be an Accredited Lender Program (ALP) CDC, as set forth in § 120.840(c), and demonstrates that it can competently fulfill its 504 program responsibilities in the proposed area.

(b) *Local Economic Area Expansion.* A CDC seeking to expand its Area of Operations into a Local Economic Area must apply in writing to the Lead SBA Office.

(c) *Multi-State CDC Expansion.* A CDC seeking to become a Multi-State CDC must apply to the SBA District Office that services the area within each State where the CDC intends to locate its principal office for that State. A CDC may apply to be a Multi-State CDC only if:

(1) The State the CDC seeks to expand into is contiguous to the State of the CDC's incorporation;

(2) The CDC demonstrates that its membership meets the requirements in § 120.822 separately for its State of incorporation and for each additional State in which it seeks to operate as a Multi-State CDC; and

(3) The CDC has a loan committee meeting the requirements of § 120.823.

§ 120.836 [Removed]

■ 21. Remove § 120.836.

■ 22. Amend § 120.837 by revising paragraph (b) and adding a new paragraph (c) to read as follows:

§ 120.837 SBA decision on application to become a new CDC or for an existing CDC to expand its Area of Operations

* * * * *

(b) SBA will notify the CDC of its decision in writing, and if the application is denied, the reasons for its decision.

(c) If a CDC is approved to operate as a Multi-State CDC, the CDC's ALP, PCLP, or Priority CDC authority will carry over into every additional State in which it is approved to operate as a Multi-State CDC.

§ 120.838 [Removed]

■ 23. Remove § 120.838.

■ 24. Revise § 120.839 to read as follows:

§ 120.839 Case-by-case application to make a 504 loan outside of a CDC's Area of Operations.

A CDC may apply to make a 504 loan for a Project outside its Area of Operations to the District Office serving the area in which the Project will be located. The applicant CDC must demonstrate that it can adequately fulfill its 504 program responsibilities for the 504 loan, including proper servicing. The District Office may approve the application if:

(a) The applicant CDC has previously assisted the business to obtain a 504 loan; or

(b) The existing CDC or CDCs serving the area agree to permit the applicant CDC to make the 504 loan; or

(c) There is no CDC within the Area of Operations.

■ 25. Revise § 120.840 to read as follows:

§ 120.840 Accredited Lenders Program (ALP).

(a) *General.* Under the ALP program, SBA designates qualified CDCs as ALP CDCs, gives them increased authority to process, close, and service 504 loans, and provides expedited processing of loan approval and servicing actions.

(b) *Application.* A CDC must apply for ALP status to the Lead SBA Office. The Lead SBA Office will send its recommendation and the application to the AA/FA for final decision.

(c) *Eligibility.* In order for a CDC to be eligible to receive ALP status, its application must show that it meets the criteria set forth in § 120.841.

(d) *Additional application requirements.* The CDC's application must include the following:

(1) Certified copy of the CDC's Board of Directors' resolution authorizing the application for ALP status.

(2) Summary of the experience of each of the CDC's loan processing, closing, and servicing staff members with significant authority.

(3) Name, address, and summary of experience of Designated Attorney.

(4) Documentation of any SBA required insurance.

(5) Any other documentation required by SBA.

(e) *Term of ALP designation.* SBA generally will designate a CDC as an ALP CDC for a two-year period. SBA may renew the designation for additional two-year periods if the CDC continues to meet the ALP program eligibility requirements.

(f) *SBA approval or decline decision.* SBA will notify the CDC in writing of an approval or decline of either an ALP application or of an ALP renewal. If the SBA approves the CDC's application, the ALP CDC may exercise its ALP authority in its entire Area of Operations. If an application or renewal is declined, SBA will notify the CDC of the reasons for the decision.

■ 26. Add a new § 120.841 to read as follows:

§ 120.841 Qualifications for the ALP.

An applicant for ALP status must show that it substantially meets the following criteria:

(a) *CDC staff experience.* The CDC's staff must have well-trained, qualified loan officers who are knowledgeable concerning SBA's lending policies and procedures for the 504 program. The CDC must have at least one loan officer with three years of 504 loan processing experience and at least one loan officer with three years of 504 servicing experience or two years experience plus satisfactory completion of SBA-approved processing and servicing training. The same loan officer may meet these qualifications. In addition, the CDC's staff must have demonstrated satisfactorily to SBA the ability to process and service 504 loans.

(b) *Number of 504 loans approved and size of portfolio.* SBA must have approved at least 20 504 loan applications by the CDC in the most recent three years, and the CDC must have a portfolio of at least 30 active 504 loans. (An ''active'' 504 loan is a loan that was approved and closed by the CDC and has a status of either current, delinquent, or in liquidation.)

(c) *Current reviews in compliance.* SBA-conducted oversight reviews must be current (within past 12 months) for applicants for ALP status, and these reviews must have found the CDC to be in compliance with 504 program requirements imposed by statute, regulation, SOPs, policy and procedural notices, loan authorizations, Debentures, and agreements between the CDC and SBA.

(d) *Record of compliance with 504 program requirements.* The CDC must have a record of conforming to SBA's policies and procedures and of satisfactorily underwriting, closing and servicing 504 loans. SBA will consider all relevant material information, which will include but is not limited to whether the CDC meets all SBA's CDC portfolio benchmarks, when determining the CDC's record of compliance, including:

(1) Submission of satisfactory 504 loan analyses and applications, and all required, and properly completed, loan documents.

(2) Careful and thorough analysis and screening of all 504 loan applications for conformance with SBA credit and eligibility standards;

(3) Proper completion of required 504 loan closing documents and compliance with SBA 504 loan closing policies and procedures.

(4) Compliance with SBA loan servicing policies and procedures.

(5) Compliance with the certification and operational requirements as set forth in §§ 120.820 through 120.830.

(6) Submission of timely, complete and acceptable annual reports.

(7) Compliance with CDC ethical requirements (see § 120.851).

(e) *Priority CDC.* The CDC must be a Priority CDC with a Designated Attorney and SBA required insurance.

(f) *Record of Cooperation.* The CDC must have a record of effective communication and a cooperative relationship with all SBA offices including district offices and SBA's loan processing and servicing centers.

■ 27. Revise § 120.845 to read as follows:

§ 120.845 Premier Certified Lenders Program (PCLP).

(a) *General.* Under the PCLP, SBA designates qualified CDCs as PCLP CDCs and delegates to them increased authority to process, close, service, and liquidate 504 loans. SBA also may give PCLP CDCs increased authority to litigate 504 loans.

(b) *Application.* A CDC must apply for PCLP status to the Lead SBA Office. The Lead SBA Office will send its written recommendation and the application to SBA's PCLP Loan Processing Center, which will review these materials and forward them with a recommendation to the AA/FA for final decision.

(c) *Eligibility.* In order for a CDC to be eligible to receive PCLP status, its application must show that it meets the following criteria:

(1) The CDC must be an ALP CDC in substantial compliance with 504 program requirements imposed by statute, regulation, SOP, policy and procedural notices, Debentures, loan authorizations, and any agreement between SBA and the CDC or meet the criteria to be an ALP CDC set forth in § 120.841(a) through (h).

(2) The CDC can adequately comply with SBA liquidation and litigation requirements.

(d) *Additional application requirements.* The application must include the following:

(1) Certified copy of the CDC's Board of Directors' resolution authorizing the application for PCLP status.

(2) Summary of the experience of each of the CDC's loan processing, closing, servicing and liquidation staff members with significant authority.

(3) Name, address and summary of experience of Designated Attorney.

(4) Documentation of any SBA required insurance.

(5) Any other documentation required by SBA.

(e) *Term of designation.* If approved, SBA generally will confer PCLP status for a period of two years. However, if SBA deems it appropriate, it may confer PCLP status for a period of less than two years.

(f) *Area of Operations for PCLP CDCs.* If the SBA approves the CDC's application, the PCLP CDC may exercise its PCLP authority in its entire Area of Operations.

(g) *SBA approval or decline decision.* SBA will notify the CDC in writing of an approval or decline of a PCLP application. If an application is declined, SBA will notify the CDC of the reasons for the decision.

■ 27a. Add §§ 120.846 through 120.848 to read as follows:

§ 120.846 Requirements for maintaining and renewing PCLP status.

(a) To maintain its status as a PCLP CDC, a CDC must continue to:

(1) Meet the PCLP eligibility requirements in § 120.845 .

(2) Timely conform with all requirements and deadlines set forth in SBA's regulations and policy and procedural guidance concerning properly establishing, funding and reporting a PCLP Loan Loss Reserve Fund (LLRF).

(3) Substantially comply with all 504 program requirements imposed by statute, regulation, SOPs, policy and procedural notices, loan authorizations, Debentures, and agreements between the CDC and SBA.

(4) Remain an active CDC.

(5) In accordance with statutory requirements set forth in section 508(i) of Title V, 15 U.S.C. 697e(i), establish a goal of processing at least 50 percent of its 504 loans using PCLP procedures.

(b) SBA will notify the PCLP CDC in writing of a renewal or non-renewal of PCLP status. If PCLP status is not renewed, SBA will notify the CDC of the reasons for the decision.

§ 120.847 Requirements for the Loan Loss Reserve Fund (LLRF).

(a) *General.* PCLP CDCs must establish and maintain a LLRF (or multiple accounts which together constitute one LLRF) which complies with paragraphs (b) through (g) of this section. A PCLP CDC must use the LLRF or other funds to reimburse the SBA for 10 percent of any loss sustained by SBA as a result of a default in the payment of principal or interest on a Debenture it issued under the PCLP (''PCLP Debenture''). A CDC that is participating in the PCLP as of January 1, 2004, and a CDC that has participated in the PCLP in the past but which does not have PCLP status as of that date, must establish a LLRF within 30 days of that date to cover potential losses for all 504 loans made in connection with PCLP Debentures that remain outstanding as of that date. A CDC that receives PCLP status after that date must establish and maintain a LLRF prior to closing any 504 loans processed under its PCLP status. The LLRF is the accumulation of deposits that a PCLP CDC must establish and maintain for each PCLP Debenture that it issues. PCLP CDCs must coordinate with their Lead SBA Office to ensure that the LLRF is properly established, that all necessary documentation is executed and delivered by all parties in a timely fashion, and that all required deposits are made.

(b) *PCLP CDC Exposure and LLRF deposit requirements.* A PCLP CDC's ''Exposure'' is defined as its reimbursement obligation to SBA with respect to default in the payment of any PCLP Debenture. The amount of a PCLP CDC's Exposure is 10 percent of any loss (including attorney's fees; litigation costs; and care of collateral, appraisal and other liquidation costs and expenses) sustained by SBA as a result of a default in the payment of principal or interest on a PCLP Debenture. For each PCLP Debenture a PCLP CDC issues, it must establish and maintain an LLRF equal to one percent of the original principal amount (the face amount) of the PCLP Debenture. The amount the PCLP CDC must maintain in the LLRF for each PCLP Debenture remains the same even as the principal balance of the PCLP Debenture is paid down over time.

(c) *Establishing a LLRF.* The LLRF must be a deposit account (or accounts) with a federally insured depository institution selected by the PCLP CDC. A ''deposit account'' is a demand, time, savings, or passbook account, including a certificate of deposit (CD) which is either uncertificated or, if certificated, non-transferable. A ''deposit account'' is not an investment account and must not contain securities or other investment properties. A deposit account may contain only cash and CDs credited to that account. A PCLP CDC may pool its deposits for multiple PCLP Debentures in a single account in one institution. The LLRF must be segregated from the PCLP CDC's other operating accounts. The PCLP CDC is responsible for all fees, costs and expenses incurred in connection with establishing, managing and maintaining the LLRF, including fees associated with transferring funds or early withdrawal of CDs, and related income tax expenses.

(d) *Creating and perfecting a security interest in a LLRF.* A PCLP CDC must give SBA a first priority, perfected security interest in the LLRF to secure the PCLP CDC's obligation to reimburse SBA for the PCLP CDC's Exposure under all of its outstanding PCLP Debentures. (If a PCLP CDC's LLRF is comprised of multiple deposit accounts, it must give SBA this security interest with respect to each such account.) The PCLP CDC must grant to SBA the security interest in the LLRF pursuant to a security agreement between the PCLP CDC and SBA, and a control agreement between the PCLP CDC, SBA, and the applicable depository institution. The control agreement must include provisions requiring the depository institution to follow SBA instructions regarding withdrawal from the account without a requirement for obtaining further consent from the PCLP CDC, and must restrict the PCLP CDC's ability to make withdrawals from the account without SBA consent. When establishing the LLRF, a PCLP CDC must coordinate with its Lead SBA Office to execute and deliver the required documentation. The PCLP CDC must provide to the Lead SBA Office a fully executed original of the security and control agreements. All documents must be satisfactory to SBA in both form and substance.

(e) *Schedule for contributions to a LLRF.* The PCLP CDC must contribute to the LLRF the required deposits for each PCLP Debenture in accordance with the following schedule:

(1) At least 50 percent of the required deposits to the LLRF on or about the date that it issues the PCLP Debenture.

(2) At least an additional 25 percent of the required deposits to the LLRF no later than one year after it issues the PCLP Debenture.

(3) Any remainder of the required deposits to the LLRF no later than two years after it issues the PCLP Debenture.

(f) *LLRF reporting requirements.* Each PCLP CDC must periodically report to SBA the amount in the LLRF in a form

that will readily facilitate reconciliation of the amount maintained in the LLRF with the amount required to meet a PCLP CDC's Exposure for its entire portfolio of PCLP Debentures.

(g) *Withdrawal of excess funds.* Interest and other funds in the LLRF that exceed the required minimums as set forth in paragraph (b) of this section, within the time frames set forth in paragraph (e) of this section, accrue to the benefit of the PCLP CDC. PCLP CDCs are authorized to withdraw excess funds, including interest, from the LLRF if such funds exceed the required minimums set forth in paragraph (b) of this section. The PCLP CDC must forward requests for withdrawals to the Lead SBA Office, which will verify the existence and amount of excess funds and notify the financial institution to transfer the excess funds to the PCLP CDC.

(h) *Determining SBA loss.* When a PCLP CDC has concluded the liquidation of a defaulted 504 loan made with the proceeds of a PCLP Debenture and has submitted a liquidation wrap-up report to SBA, or when SBA otherwise determines that the PCLP CDC has exhausted all reasonable collection efforts with respect to that 504 loan, SBA will determine the amount of the loss to SBA. SBA will notify the PCLP CDC of the amount of its reimbursement obligation to SBA (if any) and will explain how SBA calculated the loss.

(1) If the PCLP CDC agrees with SBA's calculations of the loss, it must reimburse SBA for ten percent of the amount of that loss no later than 30 days after SBA's notification to the PCLP CDC of the CDC's reimbursement obligation.

(2) If the PCLP CDC disputes SBA's calculations, it must reimburse SBA for ten percent of any loss amount that is not in dispute no later than 30 days after SBA's notification to the PCLP CDC of the CDC's reimbursement obligation. No later than 30 days after SBA's notification, the PCLP CDC may submit to the AA/FA or his or her delegate a written appeal of any disagreement regarding the calculation of SBA's loss. The PCLP CDC must include with that appeal an explanation of its reasons for the disagreement. Upon the AA/FA's final decision as to the disputed amount of the loss, the PCLP CDC must promptly reimburse SBA for ten percent of that amount.

(i) *Reimbursing SBA for loss.* A PCLP CDC may use funds in the LLRF or other funds to reimburse SBA for the PCLP CDC's Exposure on a defaulted PCLP Debenture. If a PCLP CDC does not satisfy the entire reimbursement obligation within 30 days after SBA's notification to the PCLP CDC's of its reimbursement obligation, SBA may cause funds in the LLRF to be transferred to SBA in order to cover the PCLP CDC's Exposure, unless the PCLP CDC has filed an appeal under paragraph (h)(2) of this section. If the PCLP CDC has filed such an appeal, SBA may cause such a transfer of funds to SBA 30 days after the AA/FA's or his or her delegate's decision. If the LLRF does not contain sufficient funds to reimburse SBA for any unpaid Exposure with respect to any PCLP Debenture, the PCLP CDC must pay SBA the difference within 30 days after demand for payment by SBA.

(j) *Insufficient funding of LLRF.* A PCLP CDC must diligently monitor the LLRF to ensure that it contains sufficient funds to cover its Exposure for its entire portfolio of PCLP Debentures. If, at any time, the LLRF does not contain sufficient funds, the PCLP CDC must, within 30 days of the earlier of the date it becomes aware of this deficiency or the date it receives notification from SBA of this deficiency, make additional contributions to the LLRF to make up this difference.

§ 120.848 Requirements for 504 loan processing, closing, servicing, liquidating, and litigating by PCLP CDCs.

(a) *General.* In processing, closing, servicing, liquidating and litigating 504 loans under the PCLP (''PCLP Loans''), the PCLP CDC must comply with 504 program requirements imposed by statute, regulation, SOPs, policy and procedural notices, loan authorizations, Debentures, and agreements between the CDC and SBA and in accordance with prudent and commercially reasonable lending standards.

(b) *Documentation of decision making.* For each PCLP Loan, the PCLP CDC must document in its files the basis for its decisions with respect to loan processing, closing, servicing, liquidating, and litigating.

(c) *Processing requirements.* SBA expects PCLP CDCs to handle most 504 loan processing situations, although SBA may require that the PCLP CDC process 504 loans involving complex or problematic eligibility issues through the SBA using standard 504 loan processing procedures. The PCLP CDC is responsible for properly determining borrower creditworthiness and establishing the terms and conditions under which the PCLP Loan will be made. The PCLP CDC also is responsible for properly undertaking such other processing actions as SBA may delegate to the PCLP CDC.

(d) *Submission of loan documents.* A PCLP CDC must notify SBA of its approval of a 504 loan by submitting to SBA's PCLP Loan Processing Center all documentation required by SBA, including SBA's PCLP eligibility checklist, signed by an authorized representative of the PCLP CDC. The PCLP Loan Processing Center will review these documents to determine whether the PCLP CDC has identified any problems with the PCLP Loan approval, and whether SBA funds are available for the PCLP Loan. If appropriate, the PCLP Processing Center will notify the PCLP CDC of the loan number assigned to the loan.

(e) *Loan and Debenture closing.* After receiving notification from SBA PCLP Loan Processing Center, the PCLP CDC is responsible for properly undertaking all actions necessary to close the PCLP Loan and Debenture in accordance with the expedited loan closing procedures applicable to a Priority CDC and with § 120.960.

(f) *Servicing, liquidation and litigation responsibilities.* The PCLP CDC generally must service, liquidate and litigate its entire portfolio of PCLP Loans, although SBA may in certain circumstances elect to handle such duties with respect to a particular PCLP Loan or Loans.

(g) *Making a 504 loan previously considered by another CDC.* A PCLP CDC also may utilize its PCLP status to process a 504 loan application from an applicant whose application was declined or rejected by another CDC operating in that same Area of Operations, if the applicant is located within that area and as long as SBA has not previously declined that applicant's 504 loan application. This may include the processing of a 504 loan application from an applicant that has withdrawn its application from another CDC.

■ 28. Revise § 120.850 to read as follows:

§ 120.850 Expiration of Associate Development Company designation.

The designation of Associate Development Company (ADC) will cease to exist on January 1, 2004. After that date, former ADCs may continue to contract with CDCs as Lender Service Providers (see part 103 of this chapter) or to perform other services.

■ 29. Add a new undesignated center heading before § 120.851 to read as follows:

Other CDC Requirements

■ 30. Revise § 120.851 to read as follows:

§ 120.851 CDC ethical requirements.

CDCs and their Associates must act ethically and exhibit good character.

They must meet all of the ethical requirements of § 120.140. In addition, they are subject to the following:

(a) Any benefit flowing to a CDC's Associate or his or her employer from activities as an Associate must be merely incidental (this requirement does not prevent an Associate or an Associate's employer from providing interim financing as described in § 120.890 or Third Party Loans as described in § 120.920, as long as such activity does not violate § 120.140); and

(b) A CDC's Associate may not be an officer, director, or manager of more than one CDC.

■ 31. Revise § 120.852 to read as follows:

§ 120.852 Restrictions regarding CDC participation in the Small Business Investment Company (SBIC) program and the 7(a) loan program.

(a) *7(a) loan program.* A CDC must not invest in or be an Affiliate of a Lender participating in the 7(a) loan program described in § 120.2(a). (For a definition of Affiliation, refer to § 121.103 of this chapter.) CDCs that already are affiliated with state development companies approved by SBA under section 501 of Title V, as of November 6, 2003 may remain Affiliates.

(b) *SBIC program.* A CDC must not directly or indirectly invest in a Licensee (as defined in § 107.50 of this chapter) licensed by SBA under the SBIC program authorized in Part A of Title III of the Small Business Investment Act, 15 U.S.C. 681 *et seq.* A CDC that has an SBA-approved investment in a Licensee as of November 6, 2003 may retain such investment.

■ 32. Redesignate § 120.973 as § 120.853 and revise redesignated § 120.853 to read as follows:

§ 120.853 Oversight and evaluation of CDCs.

SBA may conduct an operational review of a CDC. The SBA Office of Inspector General may also conduct, supervise or coordinate audits pursuant to the Inspector General Act. The CDC must cooperate and make its staff, records, and facilities available.

■ 33. Add a new undesignated center heading immediately preceding new § 120.853 to read as follows:

SBA Oversight

§ 120.855 [Removed]

■ 34. Remove § 120.855.

■ 35. Add §§ 120.854 through 120.856 to read as follows:

§ 120.854 Grounds for taking enforcement action against a CDC.

(a) *General.* The AA/FA or his or her authorized delegate may undertake one or more of the enforcement actions set forth in §§ 120.855(a) and (b) with respect to a CDC, based upon a determination that one or more of the following grounds exist:

(1) The CDC has failed to receive SBA approval for at least four 504 loans during two consecutive fiscal years;

(2) The CDC has failed to comply materially with any requirement imposed by statute, regulation, SOP, policy and procedural notice, any agreement the CDC has executed with SBA, or the terms of a Debenture or loan authorization.

(3) The CDC has made a material false statement or has failed to disclose a material fact to SBA:

(i) With respect to a 504 loan;

(ii) In applying to SBA for authority to participate in the 504 program or for any change in the CDC's participation in the 504 program; or

(iii) In any report or other disclosure of information that SBA requires.

(4) The CDC is not performing underwriting, closing, servicing, liquidation, litigation, or other actions with respect to 504 loans in a commercially reasonable or prudent manner. Supporting evidence of a CDC's commercially unreasonable or imprudent action may include, but is not limited to, failure to meet one or more of the portfolio benchmarks.

(5) The CDC fails to correct an underwriting, closing, servicing, liquidation, litigation, or reporting deficiency, or fails to take other corrective action, after receiving notice from SBA of a deficiency and the need to take corrective action, if any, within the time period specified in SBA's notice of deficiency. Such a notice must give the CDC a reasonable time, as determined by SBA in its sole discretion, to correct the deficiency.

(6) The CDC has engaged in a pattern of uncooperative behavior or taken an action that SBA determines is deleterious to the 504 program, that undermines SBA's management and administration of the 504 program, or that is not consistent with standards of good conduct. Prior to issuing a notice of a proposed enforcement action or immediate suspension under § 120.855(a) or § 120.855(b) based upon this paragraph, SBA must send prior written notice to the CDC explaining why the CDC's actions were uncooperative, deleterious to the program, undermined SBA's management of the program, or were not consistent with standards of good conduct. The prior notice must also state that the CDC's actions could give rise to a specified enforcement action, and provide the CDC with a reasonable time to cure the deficiency before any further action is taken.

(b) *ALP CDCs.* The AA/FA or his or her authorized delegate may undertake one of the enforcement actions set forth in § 120.855(c) with respect to a CDC, based upon a determination that one or more of the following grounds exist:

(1) The CDC has not continued to meet the criteria for eligibility under section 507(b) of Title V, 15 U.S.C. 697d.

(2) The CDC has failed to adhere to the SBA's rules and regulations or is violating any other applicable provision of law.

(c) *PCLP CDCs.* The AA/FA or his or her authorized delegate may undertake one of the enforcement actions set forth in § 120.855(d) with respect to a CDC, based upon a determination that one or more of the following grounds exist:

(1) The CDC has not continued to meet the criteria for eligibility under section 508(b) of Title V, 15 U.S.C. 697e.

(2) The CDC has not established or maintained the loss reserve required under this paragraph (c).

(3) The CDC has failed to adhere to the SBA's rules and regulations.

(4) The CDC is violating any other applicable provision of law.

§ 120.855 Types of enforcement actions.

(a) *Enforcement.* Upon a determination that one or more of the grounds set forth in § 120.854(a) exist, the AA/FA or his or her authorized delegate may undertake, in SBA's sole discretion, one or more of the following enforcement actions:

(1) Suspend or terminate the CDC's authority to participate in the 504 program or in any pilot or program within the 504 program established by SBA other than a CDC's authority to participate as an ALP CDC or PCLP CDC, which are governed by paragraphs (c) and (d) of this section.

(2) Suspend or terminate the CDC's authority to perform underwriting, closing, servicing, liquidation, or litigation on one or more 504 loans or to perform any other function in connection with the 504 program.

(3) Require the CDC to transfer some or all of its existing 504 loan portfolio and/or some or all of its pending 504 loan applications to SBA, another CDC, or any other entity designated by SBA. Any such transfer may be on a temporary or permanent basis, in SBA's sole discretion.

(4) Instruct the CSA to withhold payment of servicing, late and/or other fee(s) to the CDC.

(b) *Immediate suspension.* If SBA determines that one or more grounds set forth in § 120.854(a) exist and further determines that immediate action is necessary to prevent the risk of significant loss to SBA or to prevent significant impairment of the integrity of the 504 program, the AA/FA may issue a written notice of immediate suspension to a CDC, suspending all or certain activities of a CDC pertaining to the 504 program, and such suspension will be effective as of the date of the notice. SBA may combine a notice of immediate suspension with any enforcement action set forth in paragraphs (a), (c) or (d) of this section.

(c) *Suspension or termination of ALP CDC.* Upon a determination that one or more of the grounds set forth in § 120.854(b) exist, the AA/FA or his or her authorized delegate may, in SBA's sole discretion, suspend or terminate a CDC's authority to participate as an ALP CDC.

(d) *Suspension or termination of PCLP CDC.* Upon a determination that one or more of the grounds set forth in § 120.854(c) exist, the AA/FA or his or her authorized delegate may, in SBA's sole discretion, suspend or terminate a CDC's authority to participate as a PCLP CDC.

(e) *Term of suspension.* Any suspension issued under this section will be for a term determined by SBA in its sole discretion.

§ 120.856 Enforcement procedures.

(a) *SBA's notice to CDC of enforcement action.* (1) Prior to undertaking an enforcement action set forth in § 120.855(a), (c) or (d) the AA/FA or his or her authorized delegate must issue a written notice to the affected CDC identifying the proposed enforcement action, setting forth in reasonable detail the underlying facts and reasons for the proposed action and, if a suspension also is proposed, stating the term of the proposed suspension.

(2) If the AA/FA or his or her authorized delegate undertakes an immediate suspension pursuant to § 120.855(b), he or she must issue a written notice to the affected CDC identifying the scope and term of the suspension, and setting forth in reasonable detail the underlying facts and reasons for the proposed action.

(3) If a proposed enforcement action or immediate suspension is based upon information obtained from a party other than the CDC or SBA, SBA's notice of proposed action or immediate suspension will provide copies of documentation received from such third party, or the name of the third party in case of oral information, unless SBA determines that there are compelling reasons not to provide such information. If compelling reasons exist, SBA will provide a summary of the information it received to the CDC.

(b) *CDC's opportunity to object.* (1) A CDC that desires to contest a proposed enforcement action or an immediate suspension must file, within 30 calendar days of its receipt of the notice or within some other term established by SBA in its notice, a written objection with the AA/FA or other SBA official identified in the notice. Notice will be presumed to have been received within five days of the date of the notice unless the CDC can provide compelling evidence to the contrary.

(2) The objection must set forth in detail all grounds known to the CDC to contest the proposed action or immediate suspension and all mitigating factors, and must include documentation that the CDC believes is most supportive of its objection. A CDC must exhaust this administrative remedy in order to preserve its objection to a proposed enforcement action or an immediate suspension.

(3) If a CDC can show legitimate reasons why it does not understand the reasons given by SBA in its notice of the action, the CDC may request clarification from the Agency. SBA will provide the requested clarification in writing to the CDC or notify the CDC in writing that such clarification is not necessary. SBA, in its sole discretion, will further advise in writing whether the CDC may have additional time to present its objection to the notice.

(4) A CDC may request additional time to respond to SBA's notice if it can show that there are compelling reasons why it is not able to respond within the 30-day timeframe or timeframe given by the notice for response. If such a request is submitted to the Agency, SBA may, in its sole discretion, provide the CDC with additional time to respond to the notice of proposed action or immediate suspension.

(5) Prior to the issuance of a final decision by SBA under § 120.856(c), if a CDC can show that there is newly discovered material evidence which, despite the CDC's exercise of due diligence, could not have been discovered within the timeframe given by SBA to respond to a notice, or that there are compelling reasons beyond the CDC's control why it was not able to present a material fact or argument to the AA/FA or other deciding SBA official in its objection, and that the CDC has been prejudiced by not being able to present such information, the CDC may submit such information to SBA and request that the Agency consider such information in its final decision.

(c) *SBA's decision on CDC's objection to proposed action.* (1) If the affected CDC files a timely written objection to a proposed enforcement action, the AA/FA or his or her authorized delegate must issue a written notice of decision to the affected CDC advising whether SBA is undertaking the proposed enforcement action setting forth the grounds for the decision. SBA will issue such a notice of decision whenever it deems appropriate.

(2) If the affected CDC files a timely written objection to a notice of immediate suspension, the AA/FA or his or her authorized delegate must issue a written notice of final decision to the affected CDC within 90 days of receiving the CDC's objection advising whether SBA is continuing with the immediate suspension. If the CDC submits additional information to SBA after submitting its objection pursuant to § 120.856(b)(5), SBA must issue its final decision within 90 days of receiving such information.

(3) Prior to issuing a notice of decision, SBA in its sole discretion can request additional information from the affected CDC or other parties and conduct any other investigation it deems appropriate. If SBA determines, in its sole discretion, to consider an untimely objection, it must issue a notice of decision pursuant to this paragraph.

(d) *SBA's notice of final agency decision.* If SBA chooses not to consider an untimely objection or if the affected CDC fails to file a written objection to a proposed enforcement action or an immediate suspension, and if SBA continues to believe that such proposed enforcement action or immediate suspension is appropriate, the AA/FA or his or her authorized delegate must issue a written notice of decision to the affected CDC that SBA is undertaking one or more of the proposed enforcement actions against the CDC or that SBA will continue to pursue an immediate suspension of the CDC. Such a notice of decision need not state any grounds for the action other than to reference the CDC's failure to file a timely objection, and represents the final agency decision. If the affected CDC fails to file a written objection to an immediate suspension, SBA need not issue any further notice to the CDC.

(e) *Appeal to OHA.* (1) A CDC may appeal from an SBA notice of decision issued pursuant to paragraph (c) of this section to the SBA Office of Hearings and Appeals (OHA). The rules and procedures set forth in part 134 of this chapter will govern such appeals.

(2) OHA must limit its review to a determination of whether SBA's decision was arbitrary, capricious or contrary to law, or without procedure required by law. OHA must limit its review to the record that the AA/FA or his or her authorized delegate, and any other SBA officials directly involved with the decision, considered in making the final decision. If the OHA decides that SBA's decision was arbitrary, capricious, contrary to law, or without procedure required by law, the OHA must remand the matter to the AA/FA or the original deciding official for further consideration. The CDC may appeal from a reconsidered SBA decision as set forth in this paragraph (e).

(3) (i) OHA must not consider any argument, fact or other information presented by the affected CDC unless the CDC previously submitted that information to SBA:

(A) In or with the affected CDC's objection;

(B) In response to a request for information from SBA; or

(C) Pursuant to paragraph (b)(5) of this section if such information was accepted by SBA.

(ii) However, if a CDC can show that there is newly discovered material evidence which, despite the CDC's exercise of due diligence, could not have been discovered before the Agency's final decision, or that there are compelling reasons beyond the CDC's control why it was not able to present a material fact or argument to the AA/FA or other deciding SBA official prior to such decision, and that the CDC has been prejudiced by not being able to present such information to the official, the CDC may file a motion with the OHA for a remand of the matter.

(4) A decision by OHA, other than a remand, is the final agency decision.

(f) *Limit on applicability.* The procedures in this section shall only apply to an action taken by SBA pursuant to § 120.855.

■ 35b. Add a new undesignated center heading immediately preceding new § 120.854 to read as follows:

SBA Enforcement Actions

■ 35c. Redesignate § 120.981 as § 120.857.

■ 36. Revise § 120.861 to read as follows:

§ 120.861 Job creation or retention.

A Project must create or retain one Job Opportunity per an amount of 504 loan funding that will be specified by SBA from time to time in a Federal Register notice. Such Job Opportunity average remains in effect until changed by subsequent **Federal Register** publication.

■ 37. Amend § 120.862 as follows:

■ a. By revising the parenthetical at the end of paragraph (a)(4);

■ b. By revising paragraph (b)(2);

■ c. By redesignating paragraphs (b)(3) through (b)(7) as (b)(5) through (b)(9);

■ d. By adding new paragraphs (b)(3) and (b)(4), and

■ e. By revising redesignated paragraph (b)(5). The revisions and additions read as follows:

§ 120.862 Other economic development objectives.

* * * * *

(a) * * *

(4) * * * (North American Industry Classification System (NAICS), Sectors 31 ''33); or

* * * * *

(b) * * *

(2) Expansion of exports;

(3) Expansion of small businesses owned and controlled by women as defined in section 29(a)(3) of the Act, 15 U.S.C. 656(a)(3);

(4) Expansion of small businesses owned and controlled by veterans (especially service-disabled veterans) as defined in section 3(q) of the Act, 15 U.S.C. 632(q);

(5) Expansion of minority enterprise development (see § 124.103(b) of this chapter for minority groups who qualify for this description);

* * * * *

■ 38. Amend § 120.870 as follows:

■ a. By removing paragraph (b);

■ b. By redesignating paragraph (c) as paragraph (b); and

■ c. By revising paragraph (a) introductory text to read as follows:

§ 120.870 Leasing Project Property.

(a) A Borrower may use the proceeds of a 504 loan to acquire, construct, or modify buildings and improvements, and/or to purchase and install machinery and equipment located on land leased to the Borrower by an unrelated lessor if:

* * * * *

■ 39. Revise the heading of § 120.871 to read as follows:

§ 120.871 Leasing part of Project Property to another business.

* * * * *

■ 40. Amend § 120.880 by revising paragraph (b) to read as follows:

§ 120.880 Basic eligibility requirements.

* * * * *

(b) Together with its Affiliates, meet one of the size standards set forth in § 121.301(b) of this chapter.

■ 41. Revise § 120.882(c) to read as follows:

§ 120.882 Eligible Project costs for 504 loans.

* * * * *

(c) Professional fees directly attributable and essential to the Project, such as title insurance, opinion of title, architectural and engineering costs, appraisals, environmental studies, and legal fees related to zoning, permits, or platting; and

* * * * *

■ 42. Revise paragraph (d) of § 120.883 to read as follows:

§ 120.883 Eligible administrative costs for 504 loans.

* * * * *

(d) Borrower's out-of-pocket costs associated with 504 loan and Debenture closing other than legal fees (for example, certifications and the copying costs associated with them, overnight delivery, postage, and messenger services) but not to include fees and costs described in § 120.882;

* * * * *

■ 43. Amend § 120.892(b) by removing the phrase ''90 days'' and adding in its place the phrase ''120 days''.

■ 44. Revise the heading of § 120.900 to read as follows:

§ 120.900 Sources of permanent financing.

* * * * *

■ 45. Revise the heading of § 120.910 to read as follows:

§ 120.910 Borrower contributions.

* * * * *

■ 46. Revise § 120.911 to read as follows:

§ 120.911 Land contributions.

The Borrower's contribution may be land (including buildings, structures and other site improvements which will be part of the Project Property) previously acquired by the Borrower.

■ 47. Revise § 120.913 to read as follows:

§ 120.913 Limitations on any contributions by a Licensee.

Subject to part 107 of this chapter, a Licensee may provide financing for all or part of the Borrower's contribution to the Project. SBA will consider Licensee funds to be derived from federal sources if the Licensee has Leverage (as defined in § 107.50 of this chapter). If the Licensee does not have Leverage, SBA will consider the investment to be from private funds. Licensee financing must be subordinated to the 504 loan and must not be repaid at a faster rate than the Debenture. (Refer to § 120.930(a) for additional limitations.)

■ 48. Amend § 120.923 by revising the heading to read as follows:

§ 120.923 Policies on subordination.

* * * * *

■ 48a. Redesignate § 120.924 as paragraph (c) of § 120.923.

■ 49. Amend § 120.925 by adding a parenthetical at the end to read as follows:

§ 120.925 Preference.

* * * (See § 120.10 for a definition of Preference.)

■ 50. Revise § 120.926 to read as follows:

§ 120.926 Referral fee.

The CDC can receive a reasonable referral fee from the Third Party Lender if the CDC secured the Third Party Lender for the Borrower under a written contract between the CDC and the Third Party Lender. Both the CDC and the Third Party Lender are prohibited from charging this fee to the Borrower. If a CDC charges a referral fee, the CDC will be construed as a Referral Agent under part 103 of this chapter.

■ 51. Revise paragraph (b) of § 120.930 to read as follows:

§ 120.930 Amount.

* * * * *

(b) A 504 loan must not be less than $25,000.

* * * * *

■ 52. Revise § 120.931 to read as follows:

§ 120.931 504 Lending limits.

The outstanding balance of all SBA financial assistance to a Borrower and its affiliates under the 504 program covered by this part must not exceed $1,000,000 (or $1,300,000 if one or more of the public policy goals enumerated in § 120.862(b) applies to the Project).

■ 53. Revise § 120.933 to read as follows:

§ 120.933 Maturity.

From time to time, SBA will publish in the **Federal Register** the available maturities for a 504 loan and the Debenture that funds it. Such available maturities remain in effect until changed by subsequent **Federal Register** publication.

■ 54. Revise § 120.934 to read as follows:

§ 120.934 Collateral.

The CDC usually takes a second lien position on the Project Property to secure the 504 loan. Sometimes additional collateral is required. (In rare circumstances, SBA may permit other collateral substituted for Project Property.) All collateral must be insured against such hazards and risks as SBA may require, with provisions for notice to SBA and the CDC in the event of impending lapse of coverage.

■ 55. Revise the heading of § 120.935 to read as follows:

§ 120.935 Deposit from the Borrower that a CDC may require.

* * * * *

§ 120.936 [Removed]

■ 56. Remove § 120.936.

■ 57. Revise § 120.960 to read as follows:

§ 120.960 Responsibility for closing.

(a) The CDC is responsible for the 504 loan closing.

(b) The Debenture closing is the joint responsibility of the CDC and SBA.

(c) SBA may, within its sole discretion, decline to close the Debenture; direct the transfer of the 504 loan to another CDC; or cancel its guarantee of the Debenture, prior to sale, if any of the following occur:

(1) The CDC has failed to comply materially with any requirement imposed by statute, regulation, SOP, policy and procedural notice, any agreement the CDC has executed with SBA, or the terms of a Debenture or loan authorization;

(2) The CDC has failed to make or close the 504 loan or prepare the Debenture closing in a prudent or commercially reasonable manner;

(3) The CDC's improper action or inaction places SBA at risk;

(4) The CDC has failed to use required SBA forms or electronic versions of those forms;

(5) The CDC, Third Party Lender or Borrower has failed to timely disclose to SBA a material fact regarding the Project or 504 loan;

(6) The CDC, Third Party Lender or Borrower has misrepresented a material fact to SBA regarding the Project or 504 loan; or

(7) SBA determines that there has been an unremedied material adverse change, such as deterioration in the Borrower's financial condition, since the 504 loan was approved, or that approving the closing of the Debenture will put SBA at unacceptable financial risk.

■ 58. Revise the undesignated center heading immediately preceding § 120.970 to read as follows:

Servicing

■ 59. Revise § 120.970 to read as follows:

§ 120.970 Servicing of 504 loans and Debentures.

(a) In servicing 504 loans, CDCs must comply with 504 program requirements imposed by statute, regulation, SOPs, policy and procedural notices, loan authorizations, Debentures, and agreements between the CDC and SBA, and in accordance with prudent and commercially reasonable lending standards.

(b) The CDC is responsible for routine servicing including receipt and review of the Borrower's or Operating Company's financial statements on an annual or more frequent basis and monitoring the status of the Borrower and 504 loan collateral.

(c) The CDC is responsible for assuring that the Borrower makes all required insurance premium payments and has paid all taxes when due.

(d) The CDC is responsible for filing renewals and extensions of security interests on collateral for the 504 loan, as required.

(e) The CDC must timely respond to Borrower requests for loan modifications.

(f) For any 504 loan that is more than three months past due, the CDC must promptly request that SBA purchase the Debenture unless the 504 loan has an SBA-approved deferment or is in compliance with an SBA-approved plan to allow the Borrower to catch up on delinquent loan payments.

(g) The CDC must cooperate with SBA to cure defaults and initiate workouts.

(h) SBA may negotiate agreements with CDCs to liquidate 504 loans.

■ 60. Add a new undesignated center heading immediately preceding § 120.971 to read as follows:

Fees

■ 61. Revise paragraphs (a) (introductory text) and (a)(2) of § 120.971 to read as follows:

§ 120.971 Allowable fees paid by Borrower.

(a) *CDC fees.* The fees a CDC may charge the Borrower in connection with a 504 loan and Debenture are limited to the following:

* * * * *

(2) *Closing fee.* The CDC may charge a reasonable closing fee sufficient to reimburse it for the expenses of its in-house or outside legal counsel, and other miscellaneous closing costs (CDC Closing Fee). Some closing costs may be funded out of the Debenture proceeds (see § 120.883 for limitations);

* * * * *

■ 62. Revise § 120.972 to read as follows:

§ 120.972 Third Party Lender participation fee and CDC fee.

(a) *Participation fee.* For loans approved by SBA after September 30, 1996, SBA must collect a one-time fee equal to 50 basis points on the Third

Party Lender's participation in a Project when the Third Party Lender occupies a senior credit position to SBA in the Project.

(b) *CDC fee.* For loans approved by SBA after September 30, 1996, SBA must collect an annual fee from the CDC equal to 0.125 percent of the outstanding principal balance of the Debenture. The fee must be paid from the servicing fees collected by the CDC and cannot be paid from any additional fees imposed on the Borrower.

■ 63. Remove the undesignated center heading immediately preceding § 120.980.

■ 64. Remove §§ 120.980, 120.982, 120.983 and 120.984.

Dated: September 25, 2003.

Hector V. Barreto,

Administrator.

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