SBIC TechNotes

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Guidelines Concerning In-Kind Distributions of Equity Securities

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The purpose of this TechNote is to describe procedures for making In-Kind Distributions (IKD) of securities to SBA under 13 CFR 107.1580. This process requires careful attention to detail as it involves several different parties, it is generally time-sensitive, and it is driven by the dynamics of a highly volatile market for equity securities.

Since the inception of the Participating Securities program, SBA has received dozens of separate IKD transactions involving SBICs, and the total value of IKD securities received exceeds $350 million. The most important factors causing this level of activity have been the maturation of Participating Securities SBICs, the first of which were licensed in 1994, and the extremely favorable conditions in the equity markets in recent years. It is expected that with the continued maturation of SBICs' portfolios and with reasonable equity markets, the volume and dollar amount of IKD transactions may increase in the future.

Procedures within the Office of SBIC Operations

1. As with all distributions, SBICs interested in making IKD are required to notify SBA 10 business days prior to the planned distribution date. The initial contact with SBA should be a phone call between the licensee and its assigned financial analyst in the Office of SBIC Operations, to discuss the planned distribution. The SBIC then sends the analyst a written request for approval to make the distribution. This letter must contain the information noted in items A. to I. below, and must be accompanied by a draft Participating Securities Distribution Worksheet based on an estimate of the stock value to be distributed. Upon request by the SBIC, the analyst will forward the Distribution Worksheet on a computer diskette, along with written instructions on how to load and how to operate the program. We wish to emphasize that the 10 day notice period does not begin until SBA has received the Distribution Worksheet accompanied by supporting financial statement information (on SBA Form 468 or in a similar format), and the analyst receives the following information in writing:

A. The name of the company issuing the shares to be distributed;
B. The total number of shares outstanding;
C. The number of shares being distributed to SBA and to other parties by the SBIC and any affiliates;
D. The total number of shares of the company held by the SBIC and any affiliates;
E. The nature of the acquisition of shares and the acquisition dates;
F. Information on the cause of the distribution: underwriters lock up release, Rule 144 holding period expiration, registration statement, or re-sale prospectus becoming effective;
G. The date the shares first became available for sale or distribution by the SBIC;
H. If shares carry any type of restrictive legend, contact information for appropriate counsel designated by the company to answer questions about the restrictions; and

I. The planned distribution date.

It must be emphasized that SBA does not guarantee approval within 10 business days in cases where difficult or unexpected issues arise. Furthermore, workload issues in the future may not enable all IKDs to be resolved within the stated 10-day period. We encourage SBICs to do advance planning and to inform SBA of potential distributions as soon as possible.

2. When an SBIC notifies SBA of a planned IKD, the analyst will provide additional instructions regarding information to be provided to SBA's disposition agent (a firm employed by SBA to advise us on issues related to proposed IKD and to assist us in disposing of the equity securities we receive). The agent will review the information provided and may contact the company or its outside counsel to confirm that the shares to be distributed to SBA are tradable.

3. IKD transactions are governed by the regulations at 13 CFR 107.1580, as updated by a final rule published in the Federal Register on December 20, 1999. This rule introduced the concept of "Distributable Securities" and added it to the list of defined terms at 13 CFR 107.50. The definition is as follows:

> *Distributable Securities* means equity securities that are determined by SBA (with the advice of a third party expert in the marketing of securities) to meet each of the following requirements:
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> (1) The securities (which may include securities that are salable pursuant to the provisions of Rule 144 (17 CFR 230.144) under the Securities Act of 1933, as amended) are saleable immediately without restriction under Federal and state securities laws;
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> (2) The securities are of a class:
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> (i) Which is listed and registered on a national securities exchange, or
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> (ii) For which quotation information is disseminated in the National Association of Securities Dealers Automated Quotation System and as to which transaction reports and last sale data are disseminated pursuant to Rule 11Aa3-1 (17 CFR 240.11Aa3-1) under the Securities Exchange Act of 1934, as amended; and
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> (3) The quantity of such securities to be distributed to SBA can be sold over a reasonable period of time without having an adverse impact upon the price of the security.

Of the three criteria for Distributable Securities, the first two, immediate salability without restriction and listing on an exchange or traded under NASDAQ, are readily determinable. With respect to the third criterion, SBA consults with its disposition agent and determines whether the quantity of the securities to be distributed to SBA can be sold over a reasonable period of time without having an adverse impact on the price of the security. On the advice of its disposition agent, SBA considers the following factors in making its determination:

A. How many shares will be distributed to SBA?
B. How volatile is the stock price?
C. How does the number of shares allotted to SBA compare with the average daily trading volume? What does that indicate about the time needed to sell the SBA shares? In general,

SBA expects that the shares should have enough existing trading volume to accommodate a disposition within approximately a two week period (10 trading days). The number of trading days is arrived at by assuming that the number of shares sold should not exceed 10 percent of the daily trading volume. This does not necessarily mean that the position will be fully exited within two weeks. However, the size of the distribution must be "manageable" within the existing market for the shares.

D. Is the distribution being made in connection with a lock up release date? If so, how many other shares are likely to be for sale on the distribution date, including shares held by parties unrelated to the SBIC and its limited partners?
E. How will SBA's share of the distribution proceeds be applied? Are the proceeds to be applied largely to prioritized payments or leverage redemption, or to SBA profit participation? A distribution consisting largely of profit participation presents SBA with less risk of actual out-of-pocket loss, and SBA may be willing to accept a larger number of shares under these conditions.
F. Will the Licensee's entire holding be distributed on the distribution date, or will there be subsequent rounds of distributions of the same securities in the near future?
G. Does SBA already have an unsold position in these securities, from a distribution from this SBIC or another licensee?

This list is not all-inclusive, but it is representative of the issues that influence the determination of whether these are Distributable Securities.

4. If SBA decides, in consultation with the disposition agent, that the stock in question constitutes a Distributable Security, SBA reviews the Distribution Worksheet and other information submitted by the SBIC. Once SBA approves the distribution calculations, a letter is issued to the licensee, signed by the Area Chief, granting approval of the planned distribution. In addition to the standard approval language, the letter includes a requirement to provide written details to the disposition agent on the distribution date. The "distribution date" is the date on which the distribution is priced.

5. In cases where SBA has decided that the stock is not Distributable, or that it is not Distributable in the quantity proposed, some options that may be available to the SBIC include the following:

A. Distribute a reduced quantity of shares with SBA's approval. The SBIC may make additional distributions after SBA liquidates its initial position.
B. Apply for an exemption from the regulation requiring pro rata distribution of securities (see 13 CFR 107.1580(a)(2)), so that proportionately more shares would be distributed to the private limited partners and SBA would receive proportionately more cash. The SBIC's application must comply with 13 CFR 107.1920.
C. Sell all of the shares and make a cash distribution rather than an In Kind Distribution to SBA and the private partners.